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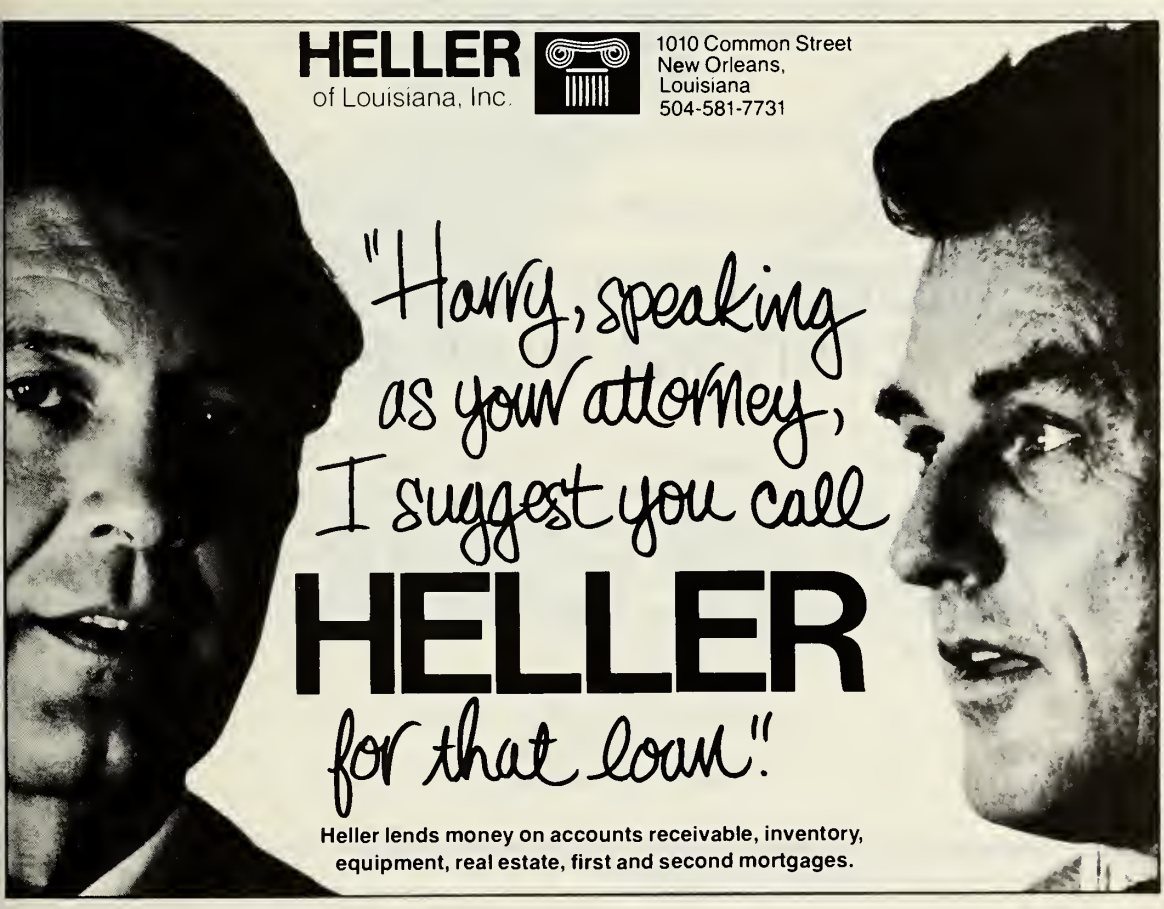

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THE ENTRAPMENT DEFENSE IN FEDERAL COURTS: MODERN DEVELOPMENTS

*Kenneth M. Murchison**

After the United States Supreme Court formally recognized the defense of entrapment during the last days of national prohibition in *Sorrells v. United States*,[1] the defense largely disappeared from the reported decisions of the federal courts for over a decade.[2] In the late 1940's and early 1950's, however, federal defendants again began to raise the defense with increasing frequency.[3] The present discussion picks up the development of the entrapment doctrine in 1958 when it resurfaced in the Supreme Court. The article examines the four modern Supreme Court decisions as well as leading opinions of the courts of appeals and offers conclusions concerning the current limitations of the defense in the federal courts.

I. Entrapment as a Matter of Law

The Supreme Court returned to a discussion of entrapment in two companion cases decided in 1958, *Sherman v. United States*[4] and *Masciale v. United States*.[5] In each case, the trial court had submitted the entrapment issue to the jury that convicted the defendant, so the

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The opinions expressed herein are those of the author and do not necessarily represent the official views of the Department of the Air Force or any other agency of the United States Government.

[1] 287 U.S. 435 (1932). The first part of this study considered the early development of the doctrine of entrapment. *See* Murchison, *The Entrapment Defense in Federal Courts: Emergence of a Legal Doctrine*, 47 Miss. L.J. 211 (1976).

[2] *See* Murchison, *supra* note 1, at 233-34.

[3] *See, e.g.*, Henderson v. United States, 237 F.2d 169 (5th Cir. 1956); Hamilton v. United States, 221 F.2d 611 (5th Cir. 1955); Trice v. United States, 211 F.2d 513 (9th Cir.), *cert. denied*, 348 U.S. 900 (1954); Demos v. United States, 205 F.2d 596 (5th Cir.), *cert. denied*, 346 U.S. 873 (1953); Cook v. United States, 193 F.2d 373 (D.C. Cir. 1951); United States v. Perkins, 190 F.2d 49 (7th Cir. 1951). During the post-*Sorrells* period, Judge Learned Hand of the Second Circuit made the most determined effort to systematize the entrapment doctrine. *See* United States v. Sherman, 200 F.2d 880 (2d Cir. 1953), *appeal after remand*, 240 F.2d 949 (1957), *rev'd*, 356 U.S. 369 (1958); United States v. Chiarella, 184 F.2d 903, 908 (2d Cir. 1950), *modified on other grounds*, 187 F.2d 12 (2d Cir.), *vacated*, 341 U.S. 946 (1951); United States v. Becker, 62 F.2d 1007 (2d Cir. 1933). For an influential article discussing the cases prior to 1950, see Donnally, *Judicial Control of Informants, Spies, Stool Pigeons, and Agent Provocateurs*, 60 Yale L.J. 1091 (1951).

[4] 356 U.S. 369 (1958).

[5] 356 U.S. 386 (1958).

only remaining issue was whether the evidence established entrapment as a matter of law. *Sherman* was the first and more thorough opinion; consequently, this section begins with an analysis of that case.

In August 1951, Sherman, a narcotics addict, was receiving treatment at a doctor's office where he met another patient named Kalchinian. As a result of several accidental meetings, the two addicts began to discuss "mutual problems and experiences," and Kalchinian eventually broached the subject of narcotics. Kalchinian claimed that he was not responding to treatment and asked Sherman to supply him with a drug source. Sherman initially attempted to avoid the issue, but finally relented "after a number of repetitions of the request, predicated on Kalchinian's presumed suffering . . . ." On several occasions thereafter, Sherman obtained narcotics which he shared with Kalchinian. The common pattern had Sherman purchasing the drugs for $25 and charging Kalchinian $15 for his share. According to Sherman, the extra $2.50 he charged Kalchinian was for taxi and other expenses. After Sherman supplied narcotics on several occasions, Kalchinian, a secret informer for the Bureau of Narcotics, notified agents of the Bureau who observed the three subsequent sales for which Sherman was convicted.[6]

The Second Circuit reversed Sherman's original conviction on the ground that the trial court had erroneously instructed the jury.[7] A new jury again convicted Sherman, and the court of appeals affirmed this second conviction.[8] The Second Circuit ruled that "the evidence was sufficient to warrant a finding 'that the accused was ready and willing to commit the offense charged, whenever the opportunity offered.' "[9] The court noted that Sherman's modus operandi was that of "an experienced trafficker in narcotics" and attached little weight to Sherman's testimony that he made no profit on the sales.[10] The court also cited Sherman's prior convictions on narcotics charges in 1942 and 1946 as

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[6] Sherman v. United States, 356 U.S. 369, 371 (1958). Both opinions of the Second Circuit also contain relatively complete discussions of the *Sherman* facts. *See* United States v. Sherman, 200 F.2d 880, 881 (2d Cir. 1952), *appeal after remand*, 240 F.2d 949, 950-51 (2d Cir. 1957).

[7] United States v. Sherman, 200 F.2d 880 (2d Cir. 1952). With an implicit criticism of the trial judge's "colloquial charge," the court held that the case was not "presented to the jury in such terms that they could apply the law as we understand it." *Id.* at 883. At the original trial, the prosecution had not offered Sherman's prior convictions into evidence. The Second Circuit hinted that, without such evidence of predisposition, it would find entrapment as a matter of law. The court did not rule precisely on this issue because of the instructional error. *Id.*

[8] Sherman v. United States, 240 F.2d 949 (1957).

[9] *Id.* at 951.

[10] *Id.* On the issue of profit, the court ruled that the jury could have disbelieved Sherman because of testimony from Kalchinian, the informer, that he had obtained the same quantities from another source at a lower price. *Id.*

"cogent evidence of a predisposition to commit the offenses charged."[11]

The Supreme Court granted certiorari[12] and reversed.[13] Mr. Chief Justice Warren's majority opinion declared that the intervening years since *Sorrells* "have in no way detracted from the principles underlying that decision."[14] The Chief Justice, however, expanded *Sorrells* beyond its construction of the National Prohibition Act to the sweeping generalization that "Congress could not have intended that its statutes were to be enforced by tempting innocent persons into violations."[15] Despite this broad interpretation of *Sorrells*, the *Sherman* majority continued to rely on the reasoning of the earlier case. The Court emphasized that "the fact that government agents 'merely afford opportunities or facilities for the commission of the offense does not' constitute entrapment."[16] The Court said that "[e]ntrapment occurs only when the criminal conduct was 'the product of the *creative* activity' of law enforcement officials."[17] In particular, the Court noted that to decide whether the evidence established entrapment, "a line must be drawn between the trap for the unwary innocent and the trap for the unwary criminal."[18] To draw the line, the majority followed *Sorrells* in permitting an accused to question the conduct of the government agent and allowing the prosecution to subject the accused "to an 'appropriate and searching inquiry into his own conduct and predisposition' . . . ."[19]

Applying these principles to the facts in *Sherman*, the Supreme Court concluded that the evidence established entrapment as a matter of law. Disclaiming any intent to choose between conflicting witnesses or to judge credibility, the Court claimed to arrive at its decision "from the undisputed testimony of the prosecution's witnesses."[20] According to the Chief Justice, it was "patently clear" that Kalchinian, the government informer, induced Sherman to commit the crime. The majority emphasized four factors in support of this conclusion: Kalchinian's initiation of the requests when he believed Sherman was undergoing a cure for narcotics addiction, Kalchinian's play on Sherman's sympathy by feigning suffering, the need for numerous requests, and Sherman's return to drug addiction which was apparently caused by Kalchinian's actions.[21] The Chief Justice's opinion found it unimportant that Kal-

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[11] *Id.*
[12] Sherman v. United States, *cert. granted*, 353 U.S. 935 (1957).
[13] 356 U.S. 369 (1958).
[14] *Id.* at 372.
[15] *Id.*
[16] *Id.*, *quoting* Sorrells v. United States, 287 U.S. 435, 441 (1932).
[17] *Id.* (emphasis in original).
[18] *Id.*
[19] *Id.* at 373, *quoting* Sorrells v. United States, 287 U.S. 435, 451 (1932).
[20] *Id.*
[21] *Id.*

chinian was not a paid informer. It declared that "[t]he Government cannot disown Kalchinian and insist it is not responsible for his actions,"[22] when Kalchinian was an active government informer, having instigated two other prosecutions, all in an apparent attempt to secure leniency on charges pending against himself. Similarly, the Court attached little significance to evidence indicating that the sales for which Sherman was convicted were not the first he had made. They were, the Court said, "part of a course of conduct which was the product of the inducement."[23]

The majority next held inadequate the prosecution's evidence that Sherman readily consented to Kalchinian's requests. According to the majority, the government's sole evidence on this point was proof of Sherman's prior convictions for possession and sale of narcotics.[24] The Court found those convictions insufficient to prove readiness, thus illustrating the evil that entrapment was designed to overcome: the enticing of an innocent citizen into crime. "Law enforcement," the Court concluded, "does not require methods such as this."[25] The Chief Justice declined the suggestion that the Supreme Court redefine entrapment on the lines of Mr. Justice Roberts' opinion in *Sorrells*. He refused to reconsider the theoretical basis of the defense because "[t]o do so would be to decide the case on grounds rejected by the majority in *Sorrells*, and . . . not raised here or below by the parties before us."[26]

Mr. Justice Frankfurter, joined by Mr. Justices Douglas, Harlan, and Brennan, concurred in *Sherman*. The concurring Justices agreed that the facts showed entrapment as a matter of law, but employed a separate analysis.[27] The chief complaint of the minority opinion was that 40 years experience with the entrapment defense had failed to develop

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[22] *Id.* The Court also noted:

> In his testimony the federal agent in charge of the case admitted that he never bothered to question Kalchinian about the way he had made contact with [Sherman]. The Government cannot make such use of an informer and then claim disassociation through ignorance.

Id. at 374-75.

[23] *Id.* at 374. *But see* United States v. Wells, 506 F.2d 924, 926 (5th Cir. 1975) (whether four sales made over the course of a month were a single course of conduct or separate, independent transactions was an issue for the jury).

[24] 356 U.S. at 375. The majority did not address the Second Circuit's arguments that Sherman evidenced the modus operandi of an experienced drug trafficker or that the jury could have disbelieved Sherman's claim of no profit. United States v. Sherman, 240 F.2d at 951.

[25] 356 U.S. at 376.

[26] *Id.*; *cf.* Casey v. United States, 276 U.S. 413, 419-20 (1928). The Chief Justice ignored the fact that *Sorrells* fashioned a theory that had not been suggested by either of the parties to that case. *See* Murchison, *supra* note 1, at 229-33.

[27] 356 U.S. at 378 (1958) (concurring opinion).

the "formulated basis in reason" for the doctrine which "is the first duty of courts to construct for justifying and guiding emotion and instinct."[28] The minority contended that the majority opinion continued the confusion by failing "to give the doctrine of entrapment the solid foundation that the decisions of the lower courts and criticism of learned writers have clearly shown is needed."[29] Declaring that the lower courts had either "continued to rest decision on the narrow facts of each case, or . . . failed after penetrating effort to define a satisfactory generalization . . . ," Mr. Justice Frankfurter argued that the Court should reexamine the doctrine "to achieve clarity of thought, because confused and inadequate analysis is too apt to lead gradually to a course of decisions that diverges from the true ends to be pursued."[30]

Turning to the merits of the doctrine, the minority opinion argued that the statutory construction approach of *Sorrells* was "sheer fiction." According to Mr. Justice Frankfurter, "the only legislative intention that can with any show of reason be extracted from the statute . . ."[31] is the Legislature's desire to punish the conduct in which Sherman had engaged. The real reason for the refusal to convict, he argued, was that "the methods employed on behalf of the Government to bring about conviction cannot be countenanced."[32] The minority opinion identified the authority for the defense as the Court's duty to apply standards that promote "[p]ublic confidence in the fair and honorable administration of justice, upon which ultimately depends the rule of law . . . ."[33] The

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[28] *Id.*

[29] *Id.* (footnote omitted). In a footnote, the opinion cited three law review commentaries as "excellent discussions of the problem": Donnelly, *supra* note 3; Mikell, *The Doctrine of Entrapment in the Federal Courts*, 90 U. PA. L. REV. 245 (1942); Note, *Entrapment by Government Officials*, 28 COLUM. L. REV. 1067 (1928). 356 U.S. at 378 n.1 (Frankfurter, J., concurring).

[30] 356 U.S. at 379 (footnote omitted). In the footnote, Mr. Justice Frankfurter declared that if the Court desired argument from counsel on the theoretical basis for entrapment, the appropriate disposition was to order reargument. *Id.* at 379 n.2.

[31] *Id.* at 379.

[32] *Id.* at 380.

[33] *Id.* Mr. Justice Frankfurter explained that his approach did not amount to judicial disregard of congressional intent:

> A false choice is put when it is said that either the defendant's conduct does not fall within the statute or he must be convicted. The statute is wholly directed to defining and prohibiting the substantive offense concerned and expresses no purpose, either permissive or prohibitory, regarding the police conduct that will be tolerated in the detection of crime. A statute prohibiting the sale of narcotics is as silent on the question of entrapment as it is on the admissibility of illegally obtained evidence. It is enacted, however, on the basis of certain presuppositions concerning the established legal order and the role of the courts within that system in formulating standards for the administration of criminal justice when Congress itself has not specifically legislated to that end.

minority viewed recognition of the proper basis for the defense as more than an "academic question," arguing that focusing on a fictional statutory intent distorts analysis and risks the Court's shirking "the responsibility that is necessarily in its keeping . . . ."[34]

Mr. Justice Frankfurter then defined his view of the correct test of entrapment. The crucial, albeit difficult, question was "whether the police conduct revealed in the particular case falls below standards, to which common feelings respond, for the use of governmental power."[35] He criticized the majority's references to predisposition as permitting the prosecution to introduce evidence of prior misconduct thereby raising a "substantial risk" of prejudice to the defendant. Moreover, he contended the focus on predisposition conflicted with basic notions of justice:

> No matter what the defendant's past record and present inclinations to criminality, or the depths to which he has sunk in the estimation of society, certain police conduct to ensnare him into further crime is not to be tolerated by an advanced society.[36]

By shifting the test to focus on police conduct, the Court would fashion "as objective a test as the subject matter permits"[37] and, he argued, the doctrine could then develop on a case by case basis "as new situations arise."[38] Finally, he advocated reserving the issue for the judge rather than the jury, thus enabling the judiciary to protect its own processes and to permit the "gradual evolution of explicit standards in accumulated precedents . . . ."[39]

The majority apparently intended *Masciale v. United States*,[40] the companion case to *Sherman* that affirmed a conviction despite an entrapment challenge, to illustrate a contrasting application of the *Sherman* principles. The brief *Masciale* opinion, however, is an enig-

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Specific statutes are to be fitted into an antecedent legal system.

Id. at 381.

[34] *Id.*

[35] *Id.* at 382.

[36] *Id.* at 382-83. The minority opinion stated that

> in the present case it is clear that the Court in fact reverses the conviction because of the conduct of the informer Kalchinian, and not because the Government has failed to draw a convincing picture of petitioner's past criminal conduct.

Id.

[37] *Id.* at 384. The minority had earlier emphasized that its opinion would not mean "that the police may not act so as to detect those engaged in criminal conduct and ready and willing to commit further crimes should the occasion arise." *Id.* at 383.

[38] *Id.* at 384.

[39] *Id.* at 385.

[40] 356 U.S. 386 (1958).

matic one.[41] A prime difficulty in interpreting the opinion is that the Court never offers any detailed statement of the facts in the case.[42] The majority opinion is especially unclear on what the *Sherman* opinion had termed the inducement issue. The opinion begins by noting the government's evidence of the alacrity with which Masciale responded to the undercover agent's expressed desire to purchase large quantities of high quality narcotics. The Court acknowledged Masciale's own testimony that he met the agent, whom he did not know was an undercover agent, only to help a friend impress the agent. The opinion emphasized,

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[41] A glance at *Sheppard's United States Citations* reveals that *Masciale* has been cited far less frequently than *Sherman*. In addition, scholarly literature has either ignored it or given it minimal consideration. Several of the case comments on *Sherman* omit any discussion of *Masciale*. *See* 8 AM. U.L. REV. 58 (1959); 33 N.Y.U.L. REV. 1033 (1958); 61 W. VA. L. REV. 79 (1958). Later commentaries have also given the case little or no analysis. *See, e.g.*, Note, *Entrapment in the Federal Courts—Sixty Years of Frustration*, 10 N. ENG. L. REV. 179 (1974); Comment, *Entrapment in the Federal Courts*, 1 U. SAN FRAN. L. REV. 177 (1966). Lower courts have not always cited *Masciale* even when discussing the effect of the defendant's uncontradicted testimony. *See* United States v. Bueno, 447 F.2d 903 (5th Cir. 1971), *cert. denied*, 411 U.S. 949 (1973). *But see* United States v. Jett, 491 F.2d 1078 (1st Cir. 1974).

[42] The majority opinion of the Second Circuit, which also affirmed Masciale's conviction, offers a more complete statement of the facts. United States v. Masciale, 236 F.2d 601 (2d Cir. 1956). According to the opinion of the Second Circuit, it was undisputed that the agent of the Bureau of Narcotics informally employed the informer in December 1953; that the informer introduced Masciale to the agent in January 1954; and that the agent and informer kept in frequent contact with Masciale until Masciale arranged for a sale to the agent through one Seifert. The agent testified that Masciale said he knew the right people in the narcotics trade at their first meeting, and that at later meetings Masciale said he was interested in making the sales because of his need for money. Masciale admitted his attempts to obtain narcotics after the second meeting with the agent, but he testified that the informer had urged him to get in the narcotics trade for several months prior to his first meeting with the agent. Masciale further testified that he originally met the agent to increase the informer's prestige with the agent, and that he was merely feigning cooperation at the early meeting.

The Second Circuit affirmed Masciale's conviction. It held that the government offered sufficient evidence to explain the inducement by the government agent. The court specifically referred to Masciale's boast about knowing people in the narcotics traffic and Masciale's statement, in his second meeting, that he was working on a source. The court also held that the evidence was sufficient to show the defendant's participation was not induced by the informer. On this point, the court noted Masciale's testimony that he had consistently rebuffed the informer's "importunities" and that the informer "was no longer in the picture" when Seifert finally made the sale to the agent. *Id.* at 603.

Judge Frank dissented. He attached no significance to Masciale's ready compliance with the agent's request, because Masciale "had never been guilty of the crime of illegal dealing in narcotics or anything like it." *Id.* at 604 (Frank, J., dissenting). In the absence of such evidence he would hold that the prosecution failed to rebut the entrapment defense. Judge Frank argued that there was "no rational basis for the distinction . . . between (1) a case where the officer's persuasion of the defendant is difficult and (2) one where it is easy." *Id.* at 605.

however, that "nowhere in his testimony did petitioner state that during the conversation either [the agent or the informer] tried to persuade him to enter the narcotics traffic."[43] On the other hand, the Court stated that Masciale "testified that the informer engaged in a campaign to persuade him to sell narcotics by using the lure of easy income."[43]

The Court avoided the question of whether a "campaign" such as the one to which Masciale claimed to have been subjected would constitute entrapment as a matter of law. Instead, the Court ruled that the evidence did not establish entrapment as a matter of law because the only evidence of the entrapment was Masciale's testimony which the jury was "entitled to disbelieve."[45] The Court also avoided the minority demand for an objective test "[f]or the reasons stated in [*Sherman*]."[46]

Mr. Justice Frankfurter dissented on behalf of the four-man minority that concurred in *Sherman*. He conceded that the evidence for sustaining Masciale's entrapment defense seemed "rather thin."[47] Nonetheless, he advocated a remand to the district court for a determination of the issue on the grounds that the defense should have been considered by the judge rather than the jury.[48]

II. Focus on Governmental Conduct

The response to *Sherman* among many scholars and in several federal courts of appeals concentrated on the inducement or governmental conduct element of entrapment and deemphasized the issue of predisposition. Most scholarly literature in the years following *Sherman* supported an objective test for entrapment.[49] In addition, two prestigious groups advocated statutory reform of the doctrine. The final draft of the

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[43] 356 U.S. at 387.

[44] *Id.* at 388.

[45] *Id.* The Court surmised that neither party attempted to subpoena the informer. *Id.* at 387 n.4.

[46] *Id.* at 387 n.5.

[47] *Id.* at 389 (Frankfurter, J., dissenting).

[48] *Id.*

[49] *See, e.g.*, Williams, *The Defense of Entrapment and Related Problems in Criminal Prosecution*, 28 Fordham L. Rev. 399 (1959); Comment, *Entrapment in the Federal Courts, supra* note 41; 33 N.Y.U.L. Rev. 1033 (1958). *But see* DeFeo, *Entrapment As a Defense to Criminal Responsibility: Its History, Theory and Application*, 1 U. San Fran. L. Rev. 243 (1967).

A number of commentators went beyond the minority position and advocated a constitutional basis for the entrapment defense. *See, e.g.*, Comment, *The Entrapment Doctrine in the Federal Courts, and Some State Court Comparisons*, 49 Crim. L.C. & P.S. 447 (1959); Note, *The Defense of Entrapment: A Plea for Constitutional Standards*, 20 U. Fla. L. Rev. 63 (1968); Note, *The Serpent Beguiled Me and I Did Eat* The Constitutional Status of the Entrapment Defense*, 74 Yale L.J. 942 (1965).

Model Penal Code included an objective "substantial risk" formulation of the doctrine after the American Law Institute's 1959 meeting expressed a preference for it over the original provision that followed the *Sherman* majority.[50] In 1970, the Commission for the Reform of the Federal Criminal Code also proposed an entrapment test which followed the *Sherman* minority's approach.[51]

Unlike scholars, the federal courts of appeals were, of course, bound by the Supreme Court's majority opinion. These courts, however, also tended, on occasion, to focus on the nature of the governmental conduct involved as well as the particular defendant's predisposition.[52] Eventually, three circuits held that, in certain limited situations, improper governmental conduct was itself sufficient to preclude conviction regardless of the predisposition of the defendant.[53]

As early as 1962, the Fifth Circuit, in *Williamson v. United States*,[54] emphasized the governmental conduct element of entrapment, although the court did not completely eliminate predisposition. In *Williamson*, the Internal Revenue Service hired an informer to help catch persons who were manufacturing and selling illegal whiskey. The government agreed to pay the informer $10 per day plus gas expenses. In addition, the government promised him specific sums if he assisted in the capture of three named individuals: "$200.00 for Big Boy [the defendant Wil-

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[50] MODEL PENAL CODE § 2.13 (Proposed Official Draft 1962); MODEL PENAL CODE § 2.10 (Tent. Draft No. 9, 1959). State legislators apparently have preferred the subjective alternative. *See* Note, *supra* note 41, at 226-35. *See also* 36 ALI PROCEEDINGS 225-34 (1959); Williams, *supra* note 49, at 415-17.

[51] NATIONAL COMMISSION ON REFORM OF FEDERAL CRIMINAL LAW, PROPOSED NEW FEDERAL CRIMINAL CODE § 702 *Entrapment* (1971). The Congress is currently considering revision of the entrapment defense in a form that may significantly differ from the Commission's recommendation. *Compare* S. 1, 93d Cong., 1st Sess. § 1-3B (1973), *with* S. 1400, 93d Cong., 1st Sess. (1973). *See also* Note, *supra* note 41, at 221-26. The entrapment section is one of the controversial provisions delaying adoption of the proposed criminal code. CONG. Q. WEEKLY REP., March 13, 1976, at 586.

[52] *See, e.g.*, United States v. Tatar, 439 F.2d 1300, 1303 (9th Cir.), *cert. denied*, 404 U.S. 866 (1971); United States v. Grimes, 438 F.2d 391, 393-94 (6th Cir.), *cert. denied*, 402 U.S. 989 (1971); Kadis v. United States, 373 F.2d 370, 373 (1st Cir. 1967); United States v. Morrison, 348 F.2d 1003, 1004 (2d Cir.), *cert. denied*, 382 U.S. 905 (1965); Smith v. United States, 331 F.2d 784, 789-92 (D.C. Cir. 1964); Whiting v. United States, 321 F.2d 72, 76 (1st Cir.), *cert. denied*, 375 U.S. 884 (1963); United States v. Sizer, 292 F.2d 596, 599 (4th Cir. 1961); Accardi v. United States, 257 F.2d 168, 172 (5th Cir.), *cert. denied*, 358 U.S. 883 (1958). *See also* Comment, *Elevation of Entrapment to a Constitutional Defense*. 7 U. MICH. J.L. REFORM 361, 371-78 (1974); 59 CORNELL L. REV. 546, 562-63 (1974).

[53] *See* United States v. McGrath, 468 F.2d 1027 (7th Cir. 1972), *vacated*, 412 U.S. 936, *rehearing denied*, 414 U.S. 883 (1973), *opinion on remand*, 494 F.2d 562 (7th Cir. 1974) (per curiam); Greene v. United States, 454 F.2d 783 (9th Cir. 1971); United States v. Bueno, 447 F.2d 903 (5th Cir. 1971), *cert. denied*, 411 U.S. 949 (1973).

[54] 311 F.2d 441 (5th Cir. 1962), *appeal after remand*, 340 F.2d 612 (5th Cir.), *cert. denied*, 381 U.S. 950 (1965).

liamson], $200.00 for James McBride, and $100.00 for Hogie [co-defendant Morris Lee Lowry]."[55] The informer subsequently purchased moonshine liquor for the defendants, and a jury convicted the two defendants of selling untaxed whiskey.

A divided panel of the Fifth Circuit reversed the convictions. Judge Rives' majority opinion held that "[w]ithout some justification or explanation, we cannot sanction a contingent fee agreement to produce evidence against particular named defendants as to crimes not yet committed."[56] Judge Rives viewed the opportunities for abuse as "too obvious to require elaboration," although he did mention the danger that the contingent fee arrangement might encourage the informer to "frame" a defendant or cause the informer "to induce or persuade innocent persons to commit crimes which they had no previous intent or purpose to commit."[57] Judge Brown wrote a special concurring opinion. He contended that *Williamson*, though presenting a defense akin to entrapment, was not an entrapment case; the kinship being that "the means used to 'make' the case are essentially revolting to an ordered society."[58] Judge Cameron dissented, arguing that the *Williamson* defendants had made no showing of entrapment under the traditional formulation of the defense and that the contingency fee arrangement did not differ significantly from the usual agreement between the government and informers.[59] He refused to hold that "the very fact of hiring an informer on a contingency basis is ignoble" because "[s]uch a holding would rob the Government of one of its most effective weapons in detecting crime and bringing to the bar of justice those who commit it."[60]

Other circuits either disapproved or distinguished the *Williamson* holding. The Tenth Circuit, for example, held that while the use of a contingency fee arrangement probably increases "the likelihood that an entrapment will result,"[61] this consideration alone does not establish

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[55] 311 F.2d at 442.

[56] *Id.* at 444 (footnote omitted).

[57] *Id.*

[58] *Id.* at 445 (Brown, J., concurring). In his concurring opinion, Judge Brown indicated that he would apply a similar rule with regard to addict informers. His focus was on exercising some control over the use of informers:

> What we hold is that, recognized as is the role of informer in the enforcement of criminal laws, there comes a time when enough is more than enough—it is just too much.

Id.

[59] *Id.* at 446 (Cameron, J., dissenting). Judge Cameron argued that, in effect, all informers work on contingent fee contracts, because they know their services will be terminated if they do not produce results. *Id.*

[60] *Id.*

[61] Maestas v. United States, 341 F.2d 493, 495 (10th Cir. 1965). *See also* Spivey v. United States, 508 F.2d 146 (10th Cir.), *cert. denied*, 421 U.S. 949 (1975).

entrapment as a matter of law. Similarly, the Sixth Circuit ruled that the contingency fee "method of paying the informers might raise questions as to their credibility and the weight to be given to their testimony but it would not invalidate the testimony."[62] Comparable language may be found in decisions of the First,[63] Second,[64] Fourth,[65] and Ninth[66] Circuits.

Williamson's popularity was short-lived even in the Fifth Circuit. Later cases required only a minimal showing to satisfy the justification exception,[67] and the court narrowly defined contingent fee arrangements to include only those situations where the government paid a specific sum for a specifically named suspect.[68] The magnitude of the retreat from *Williamson* is perhaps best illustrated by the Fifth Circuit's affirmance of the convictions obtained at a new trial of the *Williamson* defendants in which the informer's testimony was not introduced.[69]

The rejection of, and retreat from, *Williamson* did not end the focus on governmental conduct. In 1970, a California district court took the bold step in *United States v. Chisum*[70] of entering a judgment of acquittal based on its finding that impermissible police conduct established entrapment as a matter of law. The undisputed facts showed the following events: Government authorities had charged Paul Metzger

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[62] United States v. Baxter, 342 F.2d 773, 774 (6th Cir.), *cert. denied*, 381 U.S. 934 (1965). *See also* United States v. Kilpatrick, 477 F.2d 357 (6th Cir. 1973); United States v. Grimes, 438 F.2d 391 (6th Cir.), *cert. denied*, 402 U.S. 989 (1971); United States v. Costner, 359 F.2d 969 (6th Cir. 1966).

[63] Jett v. United States, 491 F.2d 1078 (1st Cir. 1974).

[64] United States v. Smalls, 363 F.2d 417 (2d Cir. 1966), *cert. denied*, 385 U.S. 1027 (1967). *See also* United States v. Cuomo, 479 F.2d 688 (2d Cir.), *cert. denied*, 414 U.S. 1002 (1973).

[65] United States v. Crim, 340 F.2d 989 (4th Cir. 1965).

[66] Corcoran v. United States, 427 F.2d 16 (9th Cir. 1970).

[67] *See* Sears v. United States, 343 F.2d 139 (5th Cir. 1965); Hill v. United States, 328 F.2d 988 (5th Cir.), *cert. denied*, 379 U.S. 851 (1964). In *Sears*, the court held that the informer's claim that the defendant, a Georgia sheriff, was engaging in illegal activities and the defendant's special status as "a law enforcement officer sworn to uphold the law" justified the contingency arrangement. 343 F.2d at 144. In *Hill*, the court ruled that a prior record and complaints from neighbors provided a sufficient justification for the use of a contingent fee arrangement.

[68] *See* United States v. Durham, 413 F.2d 1003 (5th Cir.), *cert. denied*, 396 U.S. 839 (1969). *Durham* approved of subsistence payments to an informer plus a "$400 reward for all his work at the end of his employment," because there "was no evidence of a contingent fee arrangement between him and the federal agents whereby he would be paid a specified sum to convict a specific suspect." *Id.* at 1004.

[69] Williamson v. United States, 340 F.2d 612 (5th Cir.), *cert. denied*, 381 U.S. 950 (1965). Commentators generally disapproved the original *Williamson* holding. *See* 15 ALA. L. REV. 603 (1963); 49 VA. L. REV. 1021 (1963). *But see* Orfield, *The Defense of Entrapment in the Federal Courts*, 1967 DUKE L.J. 39, 62-63.

[70] 312 F. Supp. 1307 (C.D. Cal. 1970), *noted in* 43 U. COLO. L. REV. 127 (1971).

with dealing in counterfeit bills, and the charges received widespread coverage in the news media. After Metzger was charged, the defendant, Chisum, contacted Metzger and offered to purchase any counterfeit bills which Metzger had. Metzger notified the Secret Service which arranged for Metzger to introduce an undercover agent as his brother. Chisum repeated his purchase offer to the agent. The agent eventually delivered counterfeit bills to Chisum and then arrested him for receiving the bills.[71]

The United States District Court for the Central District of California granted Chisum's motion to dismiss but conceded some difficulty in explaining its ruling. The court recognized that the case before it was not "[t]he classic case . . . in which the government agent induces the intent of the defendant to commit the wrong."[72] It even acknowledged that "[i]f the defense of entrapment must be confined solely to the issue of intent, then the defendant's motion must fail."[73] The court, though, did not stop with that analysis. Because the United States Supreme Court cases failed to reveal "any single, well-recognized and consistent rationale for the entrapment defense,"[74] the *Chisum* opinion examined state decisions which found entrapment as a matter of law when the government supplied a defendant with contraband and later arrested him for possessing it.[75] Judging these cases consistent with language in the *Sherman* majority and concurring opinions, the court concluded that "[e]ntrapment is indistinguishable from other law enforcement practices which . . . violate due process."[76] Accordingly, the court ordered the indictment dismissed.[77]

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[71] 312 F. Supp. at 1308-09.

[72] *Id.* at 1309.

[73] *Id.* at 1310.

[74] *Id.* The court identified five reasons that courts and commentators frequently gave in support of entrapment and provided the following citations for each reason: (1) estoppel, Casey v. United States, 276 U.S. 413, 425 (1928) (Brandeis, J., dissenting); (2) constitutional concepts of due process, Raley v. Ohio, 360 U.S. 423 (1959); Note, *Due Process and the Entrapment Defense*, 1964 ILL. L. FORUM 821; Note, *The Serpent Beguiled Me and I Did Eat* The Constitutional Status of the Entrapment Defense, supra* note 49; (3) the innocence theory, Sherman v. United States, 356 U.S. 369 (1959); Sorrells v. United States, 287 U.S. 435 (1932); (4) public policy, Ritter v. United States, 293 F. 187 (9th Cir. 1923); (5) preservation of the integrity of the judicial processes, Sherman v. United States, 356 U.S. 369, 376 (1959)(Frankfurter, J., concurring); Sorrells v. United States, 287 U.S. 435, 445 (1932) (Roberts, J., separate opinion). *Id.*

[75] 312 F. Supp. at 1310-11, *citing* People v. Strong, 21 Ill. 2d 320, 172 N.E.2d 765 (1961); Scott v. Commonwealth, 303 Ky. 353, 197 S.W.2d 774 (1946).

[76] 312 F. Supp. at 1312. The court limited its holding by noting that "[i]f it is an offense against the laws of the United States to attempt to receive counterfeit bills, then the government may proceed against the defendant for that offense." *Id.*

[77] *Id.* The *Chisum* court concluded its opinion with the declarations that the judgment was "a judgment sustaining a motion in bar" and that the defendant had never been

A year later, the Fifth Circuit followed the lead of the *Chisum* court in finding that entrapment could be established by improper police conduct regardless of the defendant's predisposition. In *United States v. Bueno*,[78] the court faced the question of whether entrapment is established as a matter of law when a government informer supplies a defendant with drugs that the defendant then sells to an undercover agent. The Fifth Circuit ruled that such facts established entrapment as a matter of law regardless of the predisposition of the defendant. The court first noted a number of state court[79] and federal district court[80] decisions which supported the defense in the informer-supplier, agent-purchaser situation. The opinion then cited a long list of law review commentaries on entrapment, and declared:

> The defense of entrapment has undergone much maturation since first announced by the Supreme Court, and both the courts and the legal writers offer varying theories upon which it is based. . . .
>
> The facts of this case clearly fit within the framework of the law in this field. If Defendant is to be believed, the sales of heroin were made through the creative activity of the government. The Defendant would not have had the heroin to sell if it had not been purchased by the Informer. In fact, this particular heroin would apparently not have been in the United States at all, if it had not been smuggled in by the Informer.[81]

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put in jeopardy. The government apparently rejected this veiled invitation to appeal the judgment. *Id.*

[78] 447 F.2d 903 (5th Cir. 1971), *appeal after remand*, 470 F.2d 154 (5th Cir. 1972), *cert. denied*, 411 U.S. 949 (1973). The District of Columbia Circuit had earlier recognized a similar defense. That circuit distinguished its new defense from entrapment and labelled it a special "frame-up" defense. See Smith v. United States, 331 F.2d 784 (D.C. Cir. 1964). *But see* Brooke v. United States, 385 F.2d 279 (D.C. Cir. 1967).

[79] United States v. Bueno, 447 F.2d 903, 905 (5th Cir. 1971), *cert. denied*, 411 U.S. 949 (1973), *citing* State v. Boccelli, 105 Ariz. 495, 467 P.2d 740 (1970); People v. Strong, 21 Ill. 2d 320, 172 N.E.2d 765 (1961); People v. Carmichael, 80 Ill. App. 2d 293, 225 N.E.2d 458 (1967); People v. Jones, 73 Ill. App. 2d 55, 219 N.E.2d 12 (1966).

[80] United States v. Bueno, 447 F.2d 903, 905 (5th Cir. 1971), *cert. denied*, 411 U.S. 949 (1973), *citing* United States v. Dillet, 265 F. Supp. 980 (S.D.N.Y. 1966), and United States v. Silva, 180 F. Supp. 557 (S.D.N.Y. 1959). In each district court case the district judge was sitting as trier of fact without a jury, and each concluded that the government had failed to sustain its burden of proof. The *Bueno* court also cited a nonentrapment decision of the Ninth Circuit. United States v. Chisum, 436 F.2d 645 (9th Cir. 1971). The last citation might have been intended to refer to the *Chisum* case discussed at notes 70 through 77 and accompanying text *supra*.

[81] 447 F.2d 903, 906 (5th Cir. 1971), *appeal after remand*, 470 F.2d 154 (5th Cir. 1972), *cert. denied*, 411 U.S. 949 (1973). A second issue in *Bueno* was whether the defendant's uncontradicted testimony that the informer had supplied the contraband established entrapment as a matter of law. For a brief discussion of the history of this second issue, see note 190 *infra*.

As in *Williamson*, however, the particular defendant did not benefit greatly from the holding in *Bueno*. The government retried Bueno and called the informer as a witness to contradict the claim that he had supplied the contraband. The Fifth Circuit affirmed Bueno's second conviction on the ground that the conflict between the testimony of Bueno and that of the informer created a factual issue for the jury to resolve.[82]

In the same year as the first *Bueno* decision, the Ninth Circuit, in *Greene v. United States*,[83] also reversed a conviction solely on the basis of improper governmental conduct. The factual background leading to the *Greene* opinion began in September 1962 when an Internal Revenue Service undercover agent held himself out to the defendants as a "gangster," because he had heard they were looking for a connection to purchase a large quantity of moonshine whiskey. The agent later purchased 8 gallons from the defendants and advised other agents of the location of their still, which was subsequently raided. The undercover agent did not participate in the ensuing prosecution and conviction of the defendants. Consequently, when they were released from prison in November 1963, he contacted them in order to determine whether they had discovered his identity. He learned that the defendants were still unaware of his official status, and one of them later contacted him in December 1963 about resuming their prior relationship. For over 2 years the agent actively encouraged the defendants to supply him with whiskey and advised them concerning ways to overcome numerous problems in getting back into the business. During the 2-year period, the defendants sold the agent liquor on three occasions, these being the only liquor sales the defendants made. Finally, after 2 years of unsuccessfully encouraging the defendants to resume the sale of illegal liquor on a large scale, the agent arrested them and charged them with the three sales, for which they were later convicted.[84]

The Ninth Circuit reversed the convictions and ordered the indictments dismissed. The court's opinion initially noted that "[t]he events . . . reveal almost unbelievable naiveté on the part of defendants in accepting [the agent] as a representative of the 'syndicate.'"[85] The

[82] United States v. Bueno, 470 F.2d 154 (5th Cir. 1972), *cert. denied*, 411 U.S. 949 (1973). At the first trial the government did not call the informer as a witness. Thus, Bueno's testimony raising entrapment was uncontradicted and, as the court concluded, established entrapment as a matter of law. *Id.* at 155.

[83] 454 F.2d 783 (9th Cir. 1971). The opinion concerned three consolidated appeals. While the appeals were pending, the defendant Greene was murdered. Accordingly, his case was remanded to the district court with instructions to vacate the judgment and dismiss the indictment. *Id.* at 784.

[84] *Id.* at 784-86.

[85] *Id.* at 784.

court also concluded that these same events "disclose[d] wholly impermissible participation by the Government, through its regularly-employed agent . . . in a project to manufacture, sell and distribute bootleg whiskey."[86] The court enumerated six factors that required reversal: the initiation of the renewed contact by the agent after the 1962 conviction; the duration of government involvement in the activities; the substantial nature of the agent's involvement; the pressure the agent applied to encourage the defendants to resume operations; the government's reaching beyond merely attaching itself to an ongoing operation by aiding in the reestablishment of a previously terminated business; and the government agent being the only customer of the defendants.[87] The *Greene* majority did not clearly delineate the basis for its holding. It noted that "this is not an entrapment case," though asserting that the defense of improper governmental conduct was based on "the same underlying objections which render entrapment repugnant to American criminal justice."[88]

Judge Merrill dissented. He sharply distinguished the majority's holding from entrapment, arguing that entrapment is based on government agents inducing the commission of a crime, not on the government becoming an active participant in a criminal enterprise. Although he questioned the wisdom of the government's efforts to convict the "small time criminals" before the court, he did not regard it as an appropriate case for the fashioning of the new defense developed by the majority.[89]

In *United States v. McGrath*,[90] the Seventh Circuit became the third court of appeals to recognize an entrapment-type defense based solely on the conduct of government agents. The government's evidence in *McGrath* showed that the defendant, with others, had planned to counterfeit a million dollars in United States currency. Treasury agents infiltrated the conspiracy and assumed direction of it.[91] They controlled the printing of counterfeit bills and determined the manner in which the bills were to be delivered to the defendant. Declaring that "[t]he instant case puts the principles enunciated in *Sorrells* and *Sherman* to their severest test,"[92] the court reversed McGrath's conviction on the substantive count of possessing counterfeit bills but affirmed his conviction on the related conspiracy charge. The Seventh Circuit conceded that "[d]efining the predisposition test strictly, McGrath's entrapment

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[86] *Id.*

[87] *Id.* at 786-87.

[88] *Id.* at 787.

[89] *Id.* at 788-89 (Merrill, J., dissenting).

[90] 468 F.2d 1027 (7th Cir. 1972), *vacated*, 412 U.S. 936, *rehearing denied*, 414 U.S. 883 (1973), *opinion on remand*, 494 F.2d 562 (7th Cir. 1974).

[91] 468 F.2d at 1028-29.

[92] *Id.* at 1029.

defense would fail."[93] Nonetheless, the court concluded that the case fits within "the basic justifications offered by the [Supreme] Court for modifying criminal liability and the principles of statutory construction they have described."[94] In addition, the court declared that the government's activities in *McGrath* were " 'shocking to [its] sense of justice,' the same kind of response that led the *Sorrells* Court to formally recognize the entrapment defense."[95] While *Sorrells* and *Sherman* measured the police conduct by the criminality of the defendant, the Seventh Circuit found it "independently determinable" in *McGrath* because "[h]ere the police quite literally 'manufactured' the crime."[96]

Thus, by the end of 1972, three circuits had either expanded the entrapment defense to encompass certain governmental conduct regardless of the defendant's predisposition or spawned a new "governmental participation" defense that accomplished the same result. One should not, of course, exaggerate the breadth of these decisions. Most decisions in all the circuits regularly treated entrapment as raising a factual issue for the jury and focused attention on the particular defendant's predisposition to violate the law.[97] Moreover, subsequent decisions of the Fifth[98] and Ninth Circuits[99] emphasized the limited exception to normal entrapment principles carved out by *Bueno* and *Greene*. Nevertheless, the three circuits had clearly inched toward the objective test urged by Mr. Justice Frankfurter in his concurring opinion in *Sherman*, and the Supreme Court was now ready to evaluate the defense again.

III. Reaffirmation of the Subjective Test

During the 1960's and early 1970's, the Supreme Court followed a

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[93] *Id.*

[94] *Id.*

[95] *Id.* at 1030.

[96] *Id.*

[97] *See, e.g.*, United States v. Demetre, 464 F.2d 1105, 1108 (8th Cir. 1972); United States v. Pingleton, 458 F.2d 722 (7th Cir. 1972); United States v. Silver, 457 F.2d 1217, 1219-20 (3d Cir. 1972); United States v. DeVore, 423 F.2d 1069 (4th Cir.), *cert. denied*, 402 U.S. 950 (1970); United States v. Rodrigues, 422 F.2d 760, 762 (1st Cir. 1970), *cert. denied*, 401 U.S. 943 (1971); Pierce v. United States, 414 F.2d 163, 166-67 (5th Cir.), *cert. denied*, 396 U.S. 960 (1969); Robison v. United States, 379 F.2d 338, 343 (9th Cir. 1967), *vacated on other grounds*, 390 U.S. 198 (1968); United States v. Smalls, 363 F.2d 417 (2d Cir. 1966), *cert. denied*, 385 U.S. 1027 (1967); United States v. Head, 353 F.2d 566 (6th Cir. 1965); Jordan v. United States, 348 F.2d 433, 436 (10th Cir. 1965); Denison v. United States, 325 F.2d 623 (D.C. Cir. 1963).

[98] United States v. Morales, 477 F.2d 1309 (5th Cir. 1973); *cf.* United States v. Workopich, 479 F.2d 1142 (5th Cir. 1973).

[99] United States v. Granger, 475 F.2d 1022 (9th Cir.), *cert. denied*, 412 U.S. 929 (1973); United States v. Jenkins, 470 F.2d 1061 (9th Cir. 1972), *cert. denied*, 411 U.S. 920 (1973).

policy of benign neglect regarding the entrapment defense.[100] The Court denied certiorari in dozens of cases including some from every circuit.[101] In addition, the Court skirted any serious consideration of entrapment when the issue arose at the fringes of several cases. The Court used the word entrapment to explain its reversal of the convictions in *Raley v. Ohio*,[102] but the Court did not use the term as a word of art. In *Lopez*

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[100] One likely reason for this policy may have been the probability that, during most of the 1960's and early 1970's, a majority of the Supreme Court favored an objective approach that focused only on governmental conduct. Less than a year after *Sherman*, Mr. Justice Burton of the *Sherman* majority was replaced by Mr. Justice Stewart, who later authored a dissenting opinion advocating a test that focused solely on governmental conduct. *See* United States v. Russell, 411 U.S. 423, 439 (1973)(Stewart, J., dissenting). In 1962, two new Justices were appointed: Mr. Justice White, who concurred in the *Russell* majority's approach that considered predisposition as well as governmental inducement, replaced Mr. Justice Whittier, who concurred in the *Sherman* majority; and Mr. Justice Goldberg replaced Mr. Justice Frankfurter, the leading advocate of the governmental conduct approach. Although neither Mr. Justice Goldberg nor his successor in 1965, Mr. Justice Fortas, ever voted on an entrapment case, intuition suggests that both would have favored the approach that emphasized control of police actions. *See, e.g.*, Lewis v. United States, 385 U.S. 206, 212 (1966)(Brennan, J., concurring). At any rate, Mr. Justice Clark's replacement by Mr. Justice Marshall in 1967 gave the supporters of the governmental conduct approach a clear majority. The majority remained after the appointment of Mr. Chief Justice Burger in 1969 and Mr. Justice Blackmun in 1970, although the later appointment made it a five man majority of Mr. Justices Douglas, Harlan, Brennan, Stewart, and Marshall. Not until Mr. Justice Rehnquist assumed office on December 15, 1971, did a majority of the Court again favor the subjective test. Moreover, of the five who favored reaffirmation of the *Sherman* test in *Russell*, none had ever expressed any opinion on the entrapment issue as a Supreme Court Justice. Accordingly, prediction of future decisions was especially difficult inasmuch as voting in both *Sorrells* and *Sherman* had crossed typical "liberal" and "conservative" lines. *See* Note, *supra* note 41, at 189 n.55, 192 n.76. Perhaps the most significant impression one gleans from this digression is the significance a single Justice can have on the development of the law. Had Mr. Justice Stewart been appointed a year earlier or had the governmental conduct majority ever chosen to review an entrapment case, the law on the subject would likely be far different today.

[101] *E.g.*, United States v. Egger, 470 F.2d 1179 (9th Cir. 1972), *cert. denied*, 411 U.S. 954 (1973); United States v. Tharpe, 443 F.2d 12 (4th Cir.), *cert. denied*, 404 U.S. 866 (1971); Burris v. United States, 430 F.2d 399 (7th Cir. 1970), *cert. denied*, 401 U.S. 921 (1971); Kauffmann v. United States, 414 F.2d 1022 (8th Cir. 1969), *cert. denied*, 397 U.S. 962 (1970); United States v. Soles, 401 F.2d 521 (6th Cir. 1968), *cert. denied*, 394 U.S. 931 (1969); United States v. Sosa, 379 F.2d 525 (7th Cir.), *cert. denied*, 389 U.S. 845 (1967); United States v. Smalls, 363 F.2d 417 (2d Cir.), *cert. denied*, 385 U.S. 842 (1966); United States v. Laverick, 348 F.2d 708 (3d Cir.), *cert. denied*, 382 U.S. 940 (1965); United States v. Comi, 336 F.2d 856 (4th Cir. 1964), *cert. denied*, 379 U.S. 992 (1965); United States v. Whiting, 321 F.2d 72 (1st Cir.), *cert. denied*, 373 U.S. 903 (1963); Lucero v. United States, 311 F.2d 457 (10th Cir. 1962), *cert. denied*, 272 U.S. 936 (1963); Jasso v. United States, 290 F.2d 671 (5th Cir.), *cert. denied*, 368 U.S. 858 (1961); Park v. United States, 283 F.2d 253 (5th Cir. 1960), *cert. denied*, 369 U.S. 818 (1961); Badon v. United States, 269 F.2d 75 (5th Cir.), *cert. denied*, 361 U.S. 894 (1959).

[102] 360 U.S. 423 (1959); *cf.* Cox v. Louisiana, 379 U.S. 559, 571 (1967). In *Raley*, a state

v. United States,[103] Mr. Justice Harlan's majority opinion noted the Court's longstanding division on the nature of the defense, but concluded that "under any theory, entrapment has not been shown as a matter of law" and, therefore, Lopez's failure to request an entrapment instruction at trial precluded his raising the issue on appeal.[104] The only other mention the Supreme Court made of entrapment in the 1960's was in *Lewis v. United States*,[105] wherein the main issue concerned the applicability of the fourth amendment's warrant requirement when an undercover agent secured entrance to the defendant's home by misrepresenting his identity. Mr. Chief Justice Warren's majority opinion dismissed the entrapment claim in a single sentence: "Petitioner does not argue that he was entrapped, as he could not on the facts of this case . . . ."[106]

The lower courts' increased emphasis on governmental conduct persuaded the Supreme Court to fully reconsider the entrapment defense in 1973. The vehicle for the Court's reexamination was the decision of the Ninth Circuit in *United States v. Russell*.[107] The factual background of *Russell* dates to December 9, 1969, when an agent of the Bureau of Narcotics and Dangerous Drugs went to Russell's home. His assignment was to locate a factory that had recently been used for the manufacture of the drug methamphetamine, commonly known as "speed." The agent told Russell and two friends that he represented large-scale narcotics dealers who wanted to obtain methamphetamine. To secure a supply of the drug, the agent offered to supply an essential ingredient in the manufacturing process, phenyl-2-propanone. However, he attached two conditions to his offer: (1) that he see a sample of the product; and (2) that he view the laboratory in which the drug was to be manufactured. A co-defendant, John Connolly, supplied the agent with a sample, and took the agent to his house where the laboratory was located.[108]

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legislative committee chairman advised the defendants that they had the right to refuse to answer questions that might tend to incriminate them. They were later convicted for refusing to answer certain of the questions the committee asked them. The Ohio Supreme Court affirmed the convictions on the ground that a state immunity statute required the defendants to answer the questions. The Supreme Court reversed, holding that due process barred conviction when state officials had misled the defendants into believing they could refuse to answer questions that would tend to incriminate them. The district court's opinion in United States v. Chisum, 312 F. Supp. 1307, 1310-12 (C.D. Cal. 1970), probably placed undue reliance on *Raley* in elevating entrapment to a constitutional defense. *See* notes 70 through 77 *supra*. *See also* Comment, *Applying Estoppel Principles in Criminal Cases*, 78 YALE L.J. 1046, 1047-48 (1969); 43 U. COLO. L. REV. 127 (1971).

[103] 373 U.S. 427 (1963).

[104] *Id.* at 436.

[105] 385 U.S. 206 (1966).

[106] *Id.* at 208 (footnote omitted).

[107] 459 F.2d 671 (9th Cir. 1972), *rev'd*, 411 U.S. 423 (1973).

[108] 411 U.S. at 425. On this first visit to Connolly's house, the agent observed an empty

Two days later, the agent returned to Connolly's house with the phenyl-2-propanone. Connolly supplied the remaining ingredients required, and the agent witnessed the start of the manufacturing process.[109] After the manufacturing process was completed the next day, the agent returned to Connolly's home where Russell gave him one-half of the drug and sold him an additional amount for $60. The agent again returned to Connolly's house on January 6, 1970, where Connolly, having recently received a supply of phenyl-2-propanone from another source, sold the agent an additional quantity of methamphetamine.[110]

There was apparently considerable evidence offered concerning the availability of phenyl-2-propanone, the chemical ingredient supplied by the agent. The evidence indicated that the chemical was difficult, but not impossible, to obtain. Manufacturers could legally sell it only to persons with a license to purchase it, and the government had discouraged, with some success, manufacturers from selling it even to persons with the required license.[111] On the other hand, the undercover agent testified that he had seen a bottle marked "phenyl-2-propanone" on his first visit to Connolly's home, and that Connolly had apparently obtained a supply of the chemical to manufacture the second batch of methamphetamine that he purchased on January 6, 1970.

The Ninth Circuit overturned Russell's conviction because of "an intolerable degree of governmental participation in the criminal enterprise."[112] The court noted that *Bueno* and *Greene* had given alternate theories to explain the defense and declined to choose between the two. Both theories, the court contended, "are premised on fundamental concepts of due process and evince the reluctance of the judiciary to contenance [*sic*] 'overzealous law enforcement.' "[113] Consequently, the court felt that "both compel the same disposition" and directed dismissal of the indictment.[114]

Judge Trask dissented, arguing that the facts did not support the majority's conclusion that the defendants would not have obtained the phenyl-2-propanone if the government had not supplied it. Moreover, he also disapproved of

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bottle bearing the chemical label phenyl-2-propanone. *Id.*

[109] *Id.* at 426. The agent even participated in the manufacturing process to the extent of picking up some bits of foil that dropped on the floor and tossing them into a flask. *Id.*

[110] *Id.*

[111] *Id.* at 426-27, 448-49 (Stewart, J., dissenting). One commentator has asserted that illicit manufacturers of methamphetamine are wary of buying phenyl-2-propanone from legal sources for fear that it might be traced to them. 58 MINN. L. REV. 325, 325 n.1 (1973).

[112] United States v. Russell, 459 F.2d 671, 673 (9th Cir. 1972), *rev'd*, 411 U.S. 423 (1973).

[113] 459 F.2d at 674.

[114] *Id.*

> what appears . . . to be an unnecessary effort to enlarge the doctrine of entrapment beyond the limitations of the . . . Court in *Sherman* . . . and place this court among the minority who espouse the "governmental conduct" approach.[115]

The Supreme Court granted certiorari and reversed the decision of the Ninth Circuit.[116] After reviewing the factual background and the decision of the lower court, Mr. Justice Rehnquist's majority opinion briefly summarized the Supreme Court's decisions in *Sorrells* and *Sherman* and then turned to Russell's request that the Court reconsider "the theory of the entrapment defense as it is set forth [in the earlier decisions]."[117] Russell's principal contention was "that the defense should rest on constitutional grounds," to wit: that the government's high level of involvement in the drug's manufacture "violates the fundamental principles of due process."[118] In rejecting the constitutional approach, Mr. Justice Rehnquist first noted the imperfection of Russell's analogy to the exclusionary rule, applicable to searches and seizures and confessions, by pointing out that the normal governmental involvement in entrapment cases does not violate any independent constitutional right. He then expressed reluctance to frame a "rigid" due process rule that would forbid prosecution whenever "an undercover agent 'supplied an indispensable means to the commission of the crime that could not have been obtained otherwise, through legal or illegal channels.' "[119] He did avoid a direct ruling on that point, however, because the evidence indicated that "although the propanone was difficult to obtain, it was by no means impossible."[120]

Despite the rejection of Russell's constitutional claim, the majority opinion did not close the door to future recognition of a due process defense for entrapment cases. Citing *Rochin v. California*,[121] it conceded that the Court might "some day be presented with a situation in which the conduct of law enforcement agents is so outrageous that due process

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[115] *Id.* at 676 (Trask, J., dissenting).

[116] United States v. Russell, 411 U.S. 423 (1973).

[117] *Id.* at 430.

[118] *Id.*

[119] *Id.* at 431.

[120] *Id.*

[121] 342 U.S. 165 (1952). In *Rochin*, the police forced open a door to the room Rochin was in. When Rochin frustrated their efforts to seize two capsules in the room by swallowing them, the police jumped on him and tried to extract the capsules. When their efforts were unsuccessful, they handcuffed Rochin and took him to a hospital where "stomach pumping" forced him to vomit the capsules, which tests showed contained morphine. The Supreme Court reversed the conviction because "[o]n the facts of this case the conviction of [Rochin] has been obtained by methods that offend the Due Process Clause." *Id.* at 174.

principles would absolutely bar the government from . . . obtain[ing] a conviction . . . ," but concluded that "the instant case is distinctly not of that breed."[122] Mr. Justice Rehnquist then engaged in a short apology for the police conduct in *Russell*. He noted that the drug supplied by the government "was obtainable" and asserted that "[t]he illicit manufacture of drugs is not a sporadic, isolated criminal incident, but a continuing, though illegal, business enterprise."[123] To stop the manufacture, the government's only practical means of detecting the crime was, he maintained, the "infiltration of drug rings and a limited participation in their unlawful present practices," which could be accomplished only by means of undercover agents supplying "some item of value that the drug ring requires . . . ."[124] Accordingly, such law enforcement tactics neither violated "fundamental fairness" nor shocked "the universal sense of justice."[125]

Having disposed of the constitutional argument, the majority next rejected Russell's nonconstitutional argument that the Court should redefine the defense of entrapment along the lines suggested by the separate opinions of Mr. Justice Roberts in *Sorrells* and Mr. Justice Frankfurter in *Sherman*. Declining to overrule the earlier cases, the majority offered the following rationale:

> *Sorrells* is a precedent of long standing that has already been once reexamined in *Sherman* and implicitly there reaffirmed. Since the defense is not of a constitutional dimension, Congress may address itself to the question and adopt any substantive definition that it may find desirable.[126]

Acknowledging criticism of the subjective test established by *Sorrells* and *Sherman*, Mr. Justice Rehnquist perceived "at least equally cogent criticism" of the objective approach. He expressly mentioned two: the impossibility of securing convictions for transactions that transpired in secret if predisposition were no answer to the claim of inducement; and the undesirability of allowing the impermissible governmental conduct to grant immunity to one who has planned and committed a criminal act.[127]

In closing his opinion, Mr. Justice Rehnquist noted, with apparent disapproval, but without citation, that some lower courts had "un-

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[122] 411 U.S. at 431-32.

[123] *Id.* at 432.

[124] *Id.*

[125] *Id.*

[126] *Id.* at 433 (footnote omitted). The omitted footnote cited S. 1, 93d Cong., 1st Sess. § 1-3B2 (1973), as evidence that Congress was considering a legislative revision of the doctrine. See note 51, *supra*.

[127] 411 U.S. at 434-35; *cf.* Defeo, *supra* note 49, at 274-76.

doubtedly gone beyond . . . *Sorrells* and *Sherman* in order to bar prosecutions . . . ."[128] He emphasized that the correct theory made entrapment "a relatively limited defense" based on "the notion that Congress could not have intended criminal punishment for a defendant who has committed all the elements of a proscribed offense, but was induced to commit them by the government."[129] Therefore, Russell's concession that the government had presented sufficient evidence to support a finding of predisposition was "fatal to his claim of entrapment."[130]

Four Justices dissented in *Russell*, and there were two dissenting opinions. Joined by Mr. Justice Brennan in a concurring opinion, Mr. Justice Douglas stated that his view was the one previously expressed by Mr. Justices Brandeis, Roberts, and Frankfurter and quoted extensively from their opinions in *Casey, Sorrells*, and *Sherman*.[131] He would have affirmed the Ninth Circuit because "[s]upplying the chemical ingredient used in the manufacture of this batch of 'speed' made the United States an active participant in the unlawful activity."[132] The government's agents, he declared, "play a debased role when they become the instigators of the crime, or partners in its commission, or the creative brain behind the illegal scheme"[133] and that, Mr. Justice Douglas concluded, was what had occurred in *Russell*.[134]

Mr. Justice Stewart also prepared a dissenting opinion in which Mr. Justice Brennan and Mr. Justice Marshall joined. He began with the Court's "common ground that '[t]he conduct with which the defense of entrapment is concerned is the *manufacturing* of crime by law enforcement officials and their agents.' "[135] He next noted the sharp division within the Court over "the proper basis, scope, and focus [of the underlying rationale] of the entrapment defense . . . ."[136] He criticized the majority's subjective approach on two principal grounds: the fictional nature of the statutory construction argument and the misleading aspect of the "otherwise innocent" label. He then concluded that the

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[128] 411 U.S. at 435.

[129] *Id.* He emphasized that "the defense of entrapment . . . was not intended to give the federal judiciary a 'chancellor's foot' veto over law enforcement practices of which it did not approve." *Id.*

[130] *Id.* at 436.

[131] *Id.* at 436-37 (Douglas, J., dissenting), *citing* Sherman v. United States, 356 U.S. 369, 378 (1958)(Frankfurter, J., concurring); Sorrells v. United States, 287 U.S. 435, 453 (1932)(Roberts, J., separate opinion); Casey v. United States, 276 U.S. 413, 421 (1928) (Brandeis, J., dissenting).

[132] 411 U.S. at 437.

[133] *Id.* at 439.

[134] *Id.*

[135] *Id.* (Stewart, J., dissenting), *quoting* Lopez v. United States, 373 U.S. 427, 434 (1963).

[136] 411 U.S. at 439.

entrapment defense is designed "to prohibit unlawful governmental activity in instigating crime."[137]

Mr. Justice Stewart perceived an additional weakness in the application of the subjective test: It "permits the introduction into evidence of all kinds of hearsay, suspicion, and rumor—all of which would be inadmissible in any other context—in order to prove the defendant's predisposition."[138] He argued that despite cautionary instructions, the jury might consider the evidence for purposes beyond the limited basis for its admissibility. "More fundamentally," he argued, the focus of the subjective test on predisposition permitted the government to go to almost any lengths to entrap a person with a criminal record or bad reputation, "confident that his record or reputation itself will be enough to show that he was predisposed to commit the offense anyway."[139] To preclude this possibility of improper inducement, Mr. Justice Stewart would not allow "a person's alleged 'predisposition' to crime" to "expose him to government participation in the criminal transaction that would be otherwise unlawful."[140] He quickly qualified this statement with the caveat that the objective test would not make all use of undercover activity, strategy, or deception unlawful. He would, however, draw the line

> when the agents' involvement in criminal activities goes beyond the mere offering of . . . an opportunity and when their conduct is of a kind that could induce or instigate the commission of a crime by one not ready and willing to commit it . . . .[141]

In those situations, "entrapment has occurred" because "the Government has engaged in the impermissible manufacturing of crime . . . ."[142] Accordingly, "the federal courts should bar the prosecution in order to preserve the institutional integrity of the system of federal criminal justice."[143]

Analyzing the facts in the case,[144] Mr. Justice Stewart summarized the undercover agent's actions as meeting with suspected producers of

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[137] *Id.* at 442.

[138] *Id.* at 443.

[139] *Id.* at 443-44.

[140] *Id.* at 444.

[141] *Id.* at 445.

[142] *Id.*

[143] *Id.* (footnote omitted).

[144] *Id.* at 446-47. Mr. Justice Stewart initially noted that the Ninth Circuit could have remanded the case to the district court on the ground that the district judge should have considered the issue himself under the objective standard. Since the Ninth Circuit found entrapment as a matter of law, however, the dissent had to reach the merits of the defense. *Id.* at 446.

an illicit drug; requesting the drug; offering to supply and then supplying an essential, hard-to-obtain element needed for the manufacuture of the drug in exchange for one-half of the product; and purchasing an additional amount of the drug. He emphasized that phenyl-2-propanone, the ingredient supplied by the government, has no lawful purpose, that it is hard to obtain because of governmental pressure on those who manufacture it, that all of the charges against Russell stemmed from the drug produced with the ingredient from the government, and that all of the phenyl-2-propanone used in the manufacture was supplied by the government. These circumstances, he concluded, are precisely those the entrapment defense was designed to prevent:

> In this case, the chemical ingredient was available only to licensed persons, and the Government itself had requested suppliers not to sell that ingredient even to people with a license. Yet the Government agent readily offered, and supplied, that ingredient to an unlicensed person and asked him to make a certain illegal drug with it. The Government then prosecuted that person for making the drug produced *with the very ingredient* which its agent had so helpfully supplied. This strikes me as the very pattern of conduct that should be held to constitute entrapment as a matter of law.[145]

Because "[i]t is the Government's duty to prevent crime, not to promote it,"[146] Russell was entrapped, under the objective approach advocated by Mr. Justice Stewart, "regardless of his predisposition or 'innocence.' "[147]

Whatever the merits of *Russell*, it failed to develop uniformity in the application of the entrapment defense.[148] The months immediately following *Russell* produced a number of short opinions affirming convictions against entrapment challenges,[149] and the decisions as a whole reflected a perceptible deemphasis of the governmental conduct element of the entrapment defense. The Seventh Circuit was the first to retreat. The Supreme Court vacated the original decision of the court of appeals in *McGrath* in a one sentence per curiam opinion and remanded the case

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[145] *Id.* at 449 (footnote omitted).

[146] *Id.*

[147] *Id.* at 450.

[148] Several commentators foresaw the continuing confusion. *See, e.g.*, 40 BROOKLYN L. REV. 802, 816 (1974); 12 DUQUESNE L. REV. 340, 347-48 (1973); 58 MINN. L. REV. 325, 334 (1973). *But cf.* 42 FORDHAM L. REV. 454, 465-66 (1973).

[149] *See, e.g.*, United States v. Anders, 485 F.2d 562 (5th Cir. 1973)(per curiam); United States v. Dodson, 481 F.2d 656 (5th Cir. 1973) (per curiam). Several cases rejected entrapment claims without citing *Russell*. *E.g.*, United States v. Martinez, 488 F.2d 1088 (9th Cir. 1973)(per curiam); United States v. Jobe, 487 F.2d 268 (10th Cir. 1973), *cert. denied*, 416 U.S. 955 (1974); United States v. Rose, 484 F.2d 654 (5th Cir. 1973)(per curiam); United States v. Kandis, 484 F.2d 67 (3d Cir. 1973)(per curiam).

"for further consideration in light of [*Russell*]."[150] A chastened Seventh Circuit panel affirmed McGrath's conviction in a brief per curiam opinion:

> We conclude after reading the record, briefs, and supplemental briefs that [*Russell*] is the controlling law in this appeal and that the defense of entrapment was not available to McGrath. We also conclude that the government agents' involvement here does not amount to the type of outrageous conduct, "shocking to the universal sense of justice," which *Russell* suggests might preclude prosecution on due process principles.[151]

Other circuits also deemphasized governmental conduct. In *United States v. Cuomo*,[152] the defendant claimed that

> [t]he conduct of the law enforcement authorities in employing a paid informer and in providing him funds so that he could set up a narcotics buy from the defendants was so outrageous that it reached the proportion of a constitutional violation . . . .[153]

The Second Circuit treated the claim as raising "an issue akin to . . . entrapment," but summarily rejected it because "the Supreme Court, in [*Russell*] approved a situation in which the government agents provided an element much more essential to the commission of the crime than funds with which to make the purchase . . . ."[154] The same court again rejected a governmental conduct approach in a later case where the defendant was convicted of bribing an undercover agent to seek information concerning an indictment that was pending against him. In view of the abundant evidence of predisposition, the Second Circuit rejected the defendant's claim

> that the due process clause forbids the conviction of a defendant on charges which stem from his acceptance of a government offer of corrupt assistance in a criminal case pending *against himself*.[155]

The court instead declared that the question was for the jury under the majority's test in *Russell*.[156]

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[150] United States v. McGrath, 412 U.S. 936 (1973), *vacating* 468 F.2d 1027 (7th Cir. 1972). For a discussion of the original *McGrath* holding, see notes 90 through 96 and accompanying text *supra*.

[151] United States v. McGrath, 494 F.2d 562, 563 (7th Cir. 1974).

[152] 479 F.2d 688 (2d Cir.), *cert. denied*, 414 U.S. 1002 (1973).

[153] *Id.* at 691.

[154] *Id.* at 691-92.

[155] United States v. Rosner, 485 F.2d 1213, 1220 (2d Cir. 1973), *cert. denied*, 417 U.S. 950 (1974).

[156] *Id.* at 1222.

The Fifth Circuit likewise disavowed a governmental conduct approach in several post-*Russell* cases. In *United States v. Fink*,[157] the defendants recruited a pilot to fly in marihuana for them, but the pilot secretly arranged to cooperate with the government.[158] One defendant claimed that he attempted to terminate the crime by dumping the contraband overboard before it reached the United States, but the pilot-undercover agent would not let him. The Fifth Circuit refused to find entrapment as a matter of law, emphasizing that entrapment raised a factual issue for the jury.[159] In another case involving the importation of marihuana, the Fifth Circuit refused to find entrapment despite uncontradicted evidence

> that the government so thoroughly infiltrated this conspiracy that, when the plane touched down in Georgia with its cargo of marijuana, only one of the four persons on board was not a government agent, and *he* later turned state's evidence.[160]

The court summarily rejected the argument that the government's dominant role[161] constituted entrapment as a matter of law with the brief statement that the cases supporting the argument "have been emasculated by the Supreme Court's decision in [*Russell*]."[162]

Perhaps the most restrictive of the Fifth Circuit cases is *United States v. Wells*.[163] Entrapment was Wells' sole defense to charges of selling heroin on four separate occasions that covered the span of a month. The jury acquitted Wells on the first sale and convicted him on the remaining three. The court affirmed the convictions because

> [t]he evidence [was] sufficient for the jury to find that at a time between the first and second sales, when [the informer] faded from the scene and [the undercover agent] took over, Wells stopped acting at the instance of the government, and began acting freely on his own, and was willing to commit the crime whenever the opportunity was afforded.[164]

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[157] 502 F.2d 1 (5th Cir. 1974), *cert. denied*, 421 U.S. 911 (1975).

[158] *Id.* at 4. The court apparently attached little significance to the fact that the government had allowed the pilot to keep the $1,000 his co-conspirators paid him for his participation in the illegal scheme. *But cf.* Williamson v. United States, 311 F.2d 441 (5th Cir. 1962). The *Williamson* holding and its legacy are discussed in notes 54 through 60 and accompanying text *supra*. Recent cases have continued to read *Williamson* very narrowly. *See, e.g.*, United States v. Ladley, 517 F.2d 1190, 1192-93 (9th Cir. 1975); United States v. Gardner, 516 F.2d 334, 342-44 (7th Cir. 1975).

[159] 502 F.2d 1, 6 (5th Cir. 1974), *cert. denied*, 421 U.S. 911 (1975).

[160] United States v. Register, 496 F.2d 1072, 1081 (5th Cir. 1974), *cert. denied*, 419 U.S. 1120 (1975).

[161] *Id.* at 1081.

[162] *Id.*

[163] 506 F.2d 924 (5th Cir. 1975).

[164] *Id.* at 927. *But cf.* Sherman v. United States, 356 U.S. 369, 371 (1958)(sales oc-

The Tenth Circuit rebuffed an attempt to distinguish *Russell* on the basis of Mr. Justice Rehnquist's statement that the undercover agent there did not engage in illegal conduct.[165] The court held that the informer's giving of marihuana parties, holding himself out as a drug dealer, and allowing the defendant to live with him rent free did not establish entrapment as a matter of law. Reasoning that the lawfulness vel non of the informer's conduct did not answer the question whether the principles of due process had been violated, the court found it proper to consider the entire record, and concluded:

> [T]he government's conduct was not so outrageous that either the maintenance of the prosecution against the defendant or the resultant conviction violates the constitutional standard, announced in *Russell*, which requires that the government's conduct be tested against notions of fundamental fairness and the universal sense of justice.[166]

The emphasis of the *Russell* majority on the limited nature of the entrapment defense,[167] however, did not completely eliminate the focus on governmental conduct as a basis for finding entrapment as a matter of law. Dicta in some Ninth Circuit cases hinted at the possible continuing validity of *Greene*,[168] which recognized improper governmental involvement as a defense separate from, but related to, entrapment.[169] Moreover, though reversing on other grounds, the Second Circuit in *United States v. Archer*[170] strongly suggested that it would have overturned the conviction solely on the basis of governmental misconduct. The case, which involved alleged bribery of state officials, had apparently culminated an intensive investigation into corruption in the New York State judicial system. Unable to catch past wrongdoers, the government tried to infiltrate an ongoing corruption scheme by orchestrating the following events: A New York policeman, cooperating with federal officials, arrested a federal undercover agent on a false felony charge. The agent then made known his willingness to pay for a "fix," which the defendant, a state district attorney, arranged. To achieve federal jurisdiction, the federal agent left the state and arranged for a

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curred on "three occasions in November 1971").

[165] United States v. Spivey, 508 F.2d 146 (10th Cir.), *cert. denied*, 421 U.S. 949 (1975).

[166] *Id.* at 149.

[167] United States v. Russell, 411 U.S. 423, 435 (1973).

[168] United States v. Eubank, 483 F.2d 1149, 1150 (9th Cir. 1973); United States v. Pearson, 483 F.2d 809, 811 (9th Cir. 1973); United States v. Croxton, 482 F.2d 231, 234 (9th Cir. 1973). In each of the cited cases the court noted the exceptions to the general entrapment rule created by *Greene* and *Russell* and then emphasized that the Supreme Court had overruled their opinion in *Russell*. *But cf.* United States v. Greenbank, 491 F.2d 184, 186 (9th Cir.), *cert. denied*, 417 U.S. 931 (1974).

[169] *See* notes 83 through 89 and accompanying text *supra*.

[170] 486 F.2d 670 (2d Cir. 1973).

telephone call from the defendant while he was outside the state.[171]

The Second Circuit reversed the conviction on the ground that the government had failed to prove sufficient contacts with interstate commerce to justify federal jurisdiction,[172] and Judge Friendly's majority opinion leveled this blast at the federal agents:

> We do not at all share the Government's pride in its achievement of causing the bribery of a state assistant district attorney by a scheme which involved lying to New York police officers and perjury before New York judges and grand jurors; to our minds the participants' attempt to set up a federal crime for which these defendants stand convicted went beyond any proper prosecutorial role and needlessly injected the Federal Government into a matter of state concern.[173]

The Fifth Circuit continued to focus on governmental involvement in the special *Bueno* situation of an informer supplying the defendant with contraband for sale to the undercover agent with whom the informer was cooperating. Just 3 months after the Supreme Court's decision in *Russell*, a Fifth Circuit panel hinted at the continuing validity of *Bueno*. In applying the majority's subjective test to reverse a conviction, Judge Wisdom added:

> In *Russell* the Court noted the decision in *Bueno* but neither expressly approved or disapproved of its holding. The Court did not reach a review of the principle in *Bueno* because it concluded that even if such a principle were adopted the defendants there would not come within its scope.[174]

In *United States v. Oquendo*,[175] the Fifth Circuit addressed the *Bueno*

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[171] *Id.* at 672-74.

[172] *Id.* at 672. One commentator has examined the jurisdictional holding and concluded that the court's conclusion was fully justified by existing case law. Comment, *The Viability of the Entrapment Defense in the Constitutional Context*, 59 IOWA L. REV. 655, 668 n.149 (1974).

[173] 486 F.2d at 672 (footnote omitted). The court distinguished Casey v. United States, 276 U.S. 413 (1928), on three grounds: the government lacked any suspicion concerning a specific crime; the government's criminal activity went beyond the conduct charged; and the government authorized violations of state law for which its agents had the requisite criminal intent. In its opinion following the government's motion for rehearing, the court adhered to its original decision. It retreated from its dicta somewhat in the face of the government's vigorous assertion that the investigation was a proper use of governmental power:

> The case for this assertion would certainly be stronger if, as the Government advises us now, as it did not in its brief or argument, there was reason to believe that the local corruption in Queens had involved some violations of the Travel Act.

486 F.2d at 683-84.

[174] United States v. Workopich, 479 F.2d 1142, 1145 (5th Cir. 1973).

[175] 490 F.2d 161 (5th Cir. 1974), *noted in* 59 MINN. L. REV. 444 (1974). As in other

defense directly and held that "despite the fact that the defendant's predisposition to commit the crime is not a significant factor under *Bueno*, we do not feel that *Bueno* is inconsistent with *Russell*."[176] Subsequent Fifth Circuit decisions confirmed the *Oquendo* holding, [177] but other federal courts of appeals, addressing the *Bueno* situation in light of *Russell*, reached divergent results. The Third Circuit followed *Oquendo* in finding entrapment as a matter of law,[178] but the First and Eighth Circuits ruled that the normal subjective test of *Russell* governed the situation.[179] Consequently, the Supreme Court once again had to consider the entrapment defense.

The most recent reconsideration of the defense came as a result of the grant of certiorari to the Eighth Circuit[180] following its decision in *United States v. Hampton*.[181] Hampton was convicted of distributing heroin. At trial, he testified that a government informer had proposed a plan to sell a nonnarcotic substance that closely resembled heroin to certain "gullible" acquaintances of the informer. He further testified that the informer supplied the substance to him and that he consummated the sale.[182] In fact, the gullible acquaintances were undercover narcotics agents, and the substance Hampton sold was heroin. The informer contradicted Hampton's testimony, specifically denying that he had provided Hampton with the substance which Hampton sold to the undercover agents.[183]

Defense counsel requested an instruction that required the jury to find entrapment if the informer supplied the heroin regardless of Hampton's predisposition to commit the crime.[184] The trial judge refused the

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seminal Fifth Circuit decisions, the defendant did not benefit substantially from the opinion. After a retrial at which the informer contradicted his testimony, Oquendo was convicted and the Fifth Circuit affirmed his conviction. United States v. Oquendo, 505 F.2d 1307 (5th Cir. 1975).

[176] 490 F.2d at 164.

[177] United States v. Dovalina, 525 F.2d 952 (5th Cir. 1976); United States v. Minichiello, 510 F.2d 577 (5th Cir. 1975)(per curiam); United States v. Gomez-Rojas, 507 F.2d 1213 (5th Cir.), *cert. denied*, 423 U.S. 826 (1975); United States v. Mosley, 490 F.2d 1012 (5th Cir. 1974).

[178] United States v. West, 511 F.2d 1083, 1085 (3d Cir. 1975).

[179] United States v. Hampton, 507 F.2d 832 (8th Cir. 1974), *aff'd*, 96 S. Ct. 1646, 1649 (1976); United States v. Jett, 491 F.2d 1078 (1st Cir. 1974); *cf.* United States v. Gurule, 522 F.2d 20, 24 (10th Cir. 1975); United States v. Hayes, 477 F.2d 868, 870 (10th Cir. 1973)(dictum).

[180] Hampton v. United States, *cert. granted*, 420 U.S. 1003 (1975).

[181] 507 F.2d 832 (8th Cir. 1974), *aff'd*, 96 S. Ct. 1646 (1976).

[182] Hampton claimed that he and the informer previously had successfully duped one buyer with the drug. Hampton v. United States, 96 S. Ct. 1646, 1648 (1976).

[183] *Id.* at 1648.

[184] The requested instruction read as follows:

requested instruction and the Eighth Circuit affirmed Hampton's conviction. Relying on the Supreme Court's decision in *Russell*, a divided panel of the court held that *Russell* "forecloses us from considering any theory other than predisposition with respect to Hampton's entrapment defense."[185] Moreover, the court declared that even under the objective theory advocated by Hampton there was insufficient government participation to support a "government conduct" entrapment defense.[186]

Affirming Hampton's conviction, the Supreme Court split three ways. Mr. Justice Rehnquist wrote a plurality opinion in which the Chief Justice and Mr. Justice White joined.[187] The plurality made a determined effort to stamp out any vestige of the objective test for entrapment. It interpreted *Russell* not only to reaffirm the focus on predisposition but to rule out

> the possiblity that the defense of entrapment could ever be based upon governmental misconduct in a case, such as this one, where the predisposition of the defendant to commit the crime was established.[188]

The plurality also rejected any attempt to expand the *Russell* language that acknowledged the possibility of a governmental conduct defense separate from entrapment. Such a due process defense, the plurality contended, could "come into play only when the government activity in question violates some protected right of the *defendant*,"[189] not when the police merely act in concert with a defendant. Disclaiming any judicial responsibility to discourage illegal police conduct, Mr. Justice Rehn-

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> The defendant asserts that he was the victim of entrapment as to the crimes charged in the indictment.
>
> If you find that the defendant's sales of narcotics were sales of narcotics supplied to him by an informer in the employ of or acting on behalf of the government, then you must acquit the defendant because the law as a matter of policy forbids his conviction in such a case.
>
> Furthermore, under this particular defense, you need not consider the predisposition of the defendant to commit the offense charged, because if the governmental involvement through its informer reached the point that I have just defined in your own minds, then the predisposition of the defendant would not matter.

Id.

[185] United States v. Hampton, 507 F.2d 832, 835 (8th Cir. 1974). Judge Heaney dissented. He advocated following the Fifth Circuit rule that the informer-supplier, agent-purchaser situation established entrapment as a matter of law. *Id.* at 836 (Heaney, J., dissenting). He argued that *Russell* was distinguishable: "[T]he *Russell* Court specifically noted that the facts in *Russell* did not fall within the *Bueno* rationale because the chemical supplied to defendant Russell was not itself contraband." *Id.* at 837.

[186] *Id.* at 836 (majority opinion).

[187] Hampton v. United States, 96 S. Ct. 1646 (1976).

[188] *Id.* at 1649.

[189] *Id.* at 1650 (emphasis in original).

quist declared that the appropriate remedy was prosecution of the police officer, not release of the defendant. Mr. Justice Powell filed a concurring opinion in which Mr. Justice Blackmun joined.[190] He agreed that *Russell* required affirming Hampton's conviction,[191] but he disassociated himself from the plurality's position that the "concept of fundamental fairness inherent in the guarantee of due process would never prevent the conviction of a predisposed defendant, regardless of the outrageousness of police behavior . . . ."[192] Citing Judge Friendly's opinion in *Archer* with apparent approval,[193] the concurring Justices would not exclude the possibility of a defense based solely on governmental conduct[194] although they were quick to note that "cases, if any, in which proof of predisposition is not dispositive will be rare."[195]

Mr. Justice Brennan, joined by Justices Stewart and Marshall, dissented. Except for a brief paragraph explaining that it favored the objective theory of entrapment under which the police conduct alleged in *Hampton* "would plainly be held to constitute entrapment as a matter of law,"[196] the dissent did not repeat the arguments of earlier entrapment cases. Instead, it focused on the more limited contention that *Russell* was distinguishable. Mr. Justice Brennan identified two distinguishing factors: the chemical supplied in *Russell* was not contraband and the defendant in *Russell* was the participant in a continuing illegal scheme that began before the government became involved and continued after the government's involvement ended.[197] These differences, he argued, "require a different result" because when the government agent supplies the accused with contraband and directs him toward an agent-purchaser, the government's conduct "has passed the point of toleration."[198]

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[190] *Id.* (Powell, J., concurring).

[191] *Id.*

> Hampton would distinguish *Russell* on the ground that here contraband itself was supplied by the Government, while the phenyl-2-propanone supplied in *Russell* was not contraband. Given the characteristics of phenyl-2-propanone, this is a distinction without a difference and *Russell* disposes of this case.

Id. (footnote omitted). In the omitted footnote, Mr. Justice Powell noted that phenyl-2-propanone was an essential ingredient in the manufacture of methamphetamine that is very difficult to obtain. *Id.*

[192] *Id.*

[193] *Id.* at 1650-51 n.4.

[194] In light of *Russell*, Mr. Justice Powell agreed that the due process defense should not be termed entrapment. *Id.* at 1651 n.2. He did not suggest a more appropriate name.

[195] *Id.* at 1652 n.7.

[196] *Id.* at 1653 (Brennan, J., dissenting).

[197] *Id.*

[198] *Id.* The dissent expressly endorsed the *Bueno* exception that the Fifth Circuit had grafted onto the entrapment defense. *Id.* at 1653-54.

IV. Unanswered Questions

The four Supreme Court opinions dealing with entrapment have failed to produce uniformity in the area. As a consequence of the deep and longstanding division on the nature of the defense, the Court's opinions have largely ignored the periphery of the doctrine. On that periphery, the federal courts of appeals have discovered a number of subissues, and have split on most of them. This section discusses recent decisions of the circuits that address the peripheral issues. For purposes of analysis, it divides them into four categories: burden of proof, evidence of predisposition, informers, and alternate defenses.

A. Burden of Proof

Closely related to the issue of entrapment as a matter of law is the question of burden of proof. Although related, the issues are distinct: Entrapment as a matter of law is concerned with whether certain proven facts establish entrapment, while the burden of proof issue concerns who must prove the facts and what quantum of proof the party must offer. Courts have often confused the two or ignored the burden of proof question with a general comment that entrapment raises a factual issue for the jury.[199]

The classic statement of the burden of proof on entrapment is that of Judge Learned Hand in the first *Sherman* opinion:

> Therefore in such [entrapment] cases two questions of fact arise: (1) did the agent induce the accused to commit the offence charged in the indictment; (2) if so, was the accused ready and willing without persuasion and was he awaiting any propitious opportunity to commit the offence. On the first question the accused has the burden; on the second the prosecution has it.[200]

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[199] *E.g.*, United States v. Carroll, 518 F.2d 187, 188 (6th Cir. 1975); United States v. Ladley, 517 F.2d 1190, 1193-94 (9th Cir. 1975); United States v. Fletcher, 487 F.2d 22, 23 (5th Cir. 1973), *cert. denied*, 416 U.S. 958 (1974); United States v. Dodson, 481 F.2d 656, 657 (5th Cir. 1973); United States v. Lemons, 470 F.2d 135, 137 (3d Cir. 1972), *cert. denied*, 412 U.S. 929 (1973). There are also a number of cases refusing to submit the entrapment issue to the jury. *E.g.*, United States v. Bailey, 503 F.2d 969, 971 (5th Cir. 1974); United States v. Payseur, 501 F.2d 966, 970-71 (9th Cir. 1974); United States v. Smith, 489 F.2d 1330, 1334-35 (7th Cir. 1973), *cert. denied*, 416 U.S. 994 (1974); United States v. Perry, 478 F.2d 1276, 1278 (7th Cir.), *cert. denied*, 414 U.S. 1005 (1973). In the past, the decisions have not always been completely uniform. *Compare* Johnson v. United States, 317 F.2d 127 (D.C. Cir. 1963), *with* United States v. Kirk, 324 F.2d 493 (4th Cir. 1963). The more logical decisions focus on whether a jury reasonably could find entrapment from the evidence admitted; if so, the entrapment issue should go to the jury. *See, e.g.*, United States v. Glassel, 488 F.2d 143 (9th Cir. 1973), *cert. denied*, 416 U.S. 941 (1974).

[200] United States v. Sherman, 200 F.2d 880, 882-83 (2d Cir. 1952), *appeal after remand*, 240 F.2d 949 (2d Cir. 1957), *rev'd*, 356 U.S. 369 (1958).

Numerous cases have embraced Judge Hand's bifuracated test on burden of proof,[201] and one can argue that the Supreme Court implicitly endorsed it in its later *Sherman* decision.[202] The difficulties, however, in quantifying the respective burdens of proof and the conceptual difficulty of a shifting burden of proof in criminal cases led the First Circuit to express a preference for a unitary approach to the question.[203]

The First Circuit abandoned the bifurcated test in 1967. In *Kadis v. United States*,[204] the court declared: "We find . . . that consideration of inducement as a separate issue serves no useful purpose, and we believe it to be a mistake."[205] In the future, the court said, it would "look, singly, at the ultimate question of entrapment."[206] In formulating its unitary test, the court held that "[i]f the defendant shows, through government witnesses or otherwise, some indication that a government agent corrupted him, the burden of disproving entrapment will be on the government . . . ."[207] The court emphasized that a showing of solicitation alone would not place the burden on the government: "There must be some evidence tending to show unreadiness."[208] The court then tried to quantify the evidence that was required:

> One question remains: when has the defendant shown 'some evidence' of entrapment, viz., when is the burden placed upon the government to show that the defendant was not in fact corrupted by the government agent. The amount need not be so substantial as to require, if uncontroverted, a directed verdict of acquittal . . . but it must be more than a mere scintilla.[209]

The split among the circuits on the burden of proof issue has persisted after *Russell*. The Fifth Circuit has continued to endorse the bifurcated

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[201] *E.g.*, United States v. Greenberg, 444 F.2d 369 (2d Cir.), *cert. denied*, 404 U.S. 853 (1971); United States v. Smalls, 363 F.2d 417 (2d Cir. 1966), *cert. denied*, 385 U.S. 1027 (1967).

[202] *See* Sherman v. United States, 356 U.S. 369, 373-75 (1958).

[203] Kadis v. United States, 373 F.2d 370 (1st Cir. 1967); *cf.* Notaro v. United States, 363 F.2d 169 (9th Cir. 1966). The First Circuit developed the unitary approach after first reducing the defendant's burden, in a bifurcated test, from a preponderance of the evidence to the burden of going forward. Sagansky v. United States, 358 F.2d 195, 202-03 (1st Cir.), *cert. denied*, 385 U.S. 816 (1966); *see* Gorin v. United States, 313 F.2d 641, 654 (5th Cir. 1963), *cert. denied*, 379 U.S. 971 (1965). *See also* Orfield, *supra* note 69 at 69-70.

[204] 373 F.2d 370 (1st Cir. 1967).

[205] *Id.* at 373 (footnote omitted).

[206] *Id.* at 374.

[207] *Id.*

[208] *Id.*

[209] *Id.*

approach,[210] and the First and Third Circuits have applied the unitary approach of *Kadis*.[211]

B. *Evidence of Predisposition*

The Supreme Court's reaffirmation of the subjective test in *Russell* and *Hampton* means the entrapment issue normally turns on the defendant's "predispositon" to commit the crime. Not surprisingly, therefore, numerous cases have litigated the appropriateness of various forms of evidence. Essentially, the question is what constitutes the "appropriate and searching inquiry"[212] into predisposition that the defendant must anticipate when he raises an entrapment defense.

Several matters are relatively well settled. Prior convictions are admissible on the issue of predisposition,[213] but they are not conclusive.[214] Evidence of misconduct other than convictions is also admissible[215] even when it occurs subsequent to the offense for which the defendant is being charged.[216] To negate a claim of predisposition, a defen-

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[210] United States v. Bailey, 503 F.2d 969 (5th Cir. 1974); United States v. Costello, 483 F.2d 1366 (5th Cir. 1973); United States v. Jones, 473 F.2d 293 (5th Cir.), *cert. denied*, 411 U.S. 984 (1973).

The Fifth Circuit fashioned a special burden of proof rule for cases in which the informer supplied the defendant with contraband which the defendant sold to government agents, but *Hampton* has mooted its practical significance. *See* United States v. Dovalina, 525 F.2d 952, 955 n.2 (5th Cir. 1976); United States v. Gomez-Rojas, 507 F.2d 1213, 1218 (5th Cir.), *cert. denied*, 423 U.S. 826 (1975); United States v. Soto, 504 F.2d 557, 559 (5th Cir. 1974); United States v. Mosley, 496 F.2d 1012, 1015 (5th Cir. 1974); United States v. Oquendo, 490 F.2d 161, 163-64 (5th Cir. 1974); United States v. Bueno, 447 F.2d 903 (5th Cir. 1971), *cert. denied*, 411 U.S. 949 (1973). The First and Tenth Circuits refused to follow the special rule on the ground that it was inconsistent with the Supreme Court's decision in *Masciale*. See United States v. Gurule, 522 F.2d 20, 23-24 (10th Cir. 1975); United States v. Jett, 491 F.2d 1078, 1080 n.3. (1st Cir. 1974).

[211] United States v. Watson, 489 F.2d 504 (3d Cir. 1973); United States v. Principe, 482 F.2d 60 (1st Cir. 1973).

[212] Sorrells v. United States, 287 U.S. 435, 451 (1932).

[213] *See, e.g.*, Sherman v. United States, 356 U.S. 369, 375 (1958)(by implication); United States v. Perez, 493 F.2d 1339, 1344 (10th Cir. 1974); United States v. Tyson, 470 F.2d 381, 384 (D.C. Cir. 1972), *cert. denied*, 410 U.S. 985 (1973); Nutter v. United States, 412 F.2d 178, 182 (9th Cir. 1969), *cert. denied*, 410 U.S. 985 (1973).

[214] Sherman v. United States, 356 U.S. 369, 375 (1958); United States v. Meade, 491 F.2d 592, 594 (3d Cir. 1974); United States v. Watson, 489 F.2d 504 (3d Cir. 1973). Likewise, lack of prior convictions does not establish entrapment as a matter of law. *See* United States v. Russell, 411 U.S. 423 (1973)(by implication); United States v. Dickens, 524 F.2d 441, 445 (5th Cir. 1975).

[215] Pulido v. United States, 425 F.2d 1391, 1393-94 (9th Cir. 1970); *see* United States v. Principe, 482 F.2d 60, 63 (1st Cir. 1973); Robinson v. United States, 379 F.2d 338, 344 (9th Cir.), *vacated on other grounds*, 390 U.S. 198 (1968).

[216] *See* United States v. Rodriguez, 474 F.2d 587 (5th Cir. 1973). *But see* United States v. Frost, 431 F.2d 1249 (1st Cir. 1970), *cert. denied*, 401 U.S. 916 (1971)(defendant not allowed to testify concerning conversation after his arrest).

dant may testify as to his state of mind at the time the offense occurred.[217]

Recent cases have largely abandoned the requirement of some older decisions that the police justify any inducement of the accused by demonstrating a "reasonable suspicion" that the defendant was engaged in similar misconduct prior to the inducement.[218] In *United States v. Williams*[219] the Ninth Circuit rejected this requirement because its focus on police conduct is contrary to *Russell*. Even prior to *Russell*, the Third Circuit had gone beyond negating the requirement of reasonable suspicion. That court held that it is error to admit such evidence because the evidence is likely to prove unfairly prejudicial to the defendant.[220]

In post-*Russell* opinions, the courts of appeals have considered the admissibility of certain types of reputation evidence to show predisposition. The Fifth Circuit has been very liberal in admitting this evidence. In *United States v. McKinley*,[221] the court approved the use of statements by local police to prove reputation, ruling that: "When a defendant asserts the defense of entrapment, hearsay reputation evidence is admissible to prove his predisposition to commit the crime."[222] The court has even gone to the extreme of permitting a federal agent to testify concerning the defendant's reputation when the sole basis for the testimony was the agent's inspection of local police files.[223]

The Sixth Circuit has followed a more restrictive course. In *United States v. Ambrose*,[224] the government agent testified as to the defendant's reputation based on an "atlid" list[225] of possible violators of federal liquor laws. The court sternly rejected this evidence:

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[217] United States v. Hayes, 477 F.2d 868, 873 (10th Cir. 1973); *cf.* United States v. Mosley, 496 F.2d 1012, 1017 (5th Cir. 1974) (evidence of head injury admissible to disprove predisposition despite disavowal of insanity defense). *But cf.* United States v. Frost, 431 F.2d 1249 (1st Cir. 1970), *cert. denied*, 401 U.S. 916 (1971).

[218] *See, e.g.*, Trice v. United States, 211 F.2d 513 (9th Cir.), *cert. denied*, 348 U.S. 900 (1954); Lunsford v. United States, 200 F.2d 237 (10th Cir. 1952); Heath v. United States, 169 F.2d 1007 (10th Cir. 1948); Weathers v. United States, 126 F.2d 118 (5th Cir. 1942).

[219] 487 F.2d 210 (9th Cir. 1973), *cert. denied*, 416 U.S. 958 (1974).

[220] United States v. Silver, 457 F.2d 1217 (3d Cir. 1972); *cf.* United States v. DeVore, 423 F.2d 1069 (4th Cir. 1970), *cert. denied*, 402 U.S. 950 (1971); Kadis v. United States, 373 F.2d 370 (1st Cir. 1967).

[221] 493 F.2d 547 (5th Cir. 1974).

[222] *Id.* at 552; *accord*, United States v. Dickens, 524 F.2d 441, 445 (5th Cir. 1975).

[223] United States v. Fink, 502 F.2d 1, 5 (5th Cir. 1974), *cert. denied*, 421 U.S. 911 (1975).

[224] 483 F.2d 742 (6th Cir. 1973).

[225] No one was able to provide an accurate definition of "atlid." The court "speculated" that the acronym stood for "alcohol and tobacco law identification." *Id.* at 750 n.5.

> Agent Bilbo admitted that the atlid lists consists [*sic*] of names supplied by anonymous informants. He admitted that some of this anonymous information has proved reliable and some has not. On such ephemeral evidence, without even an attempt to satisfy the requirements ordinarily imposed upon the introduction of reputation evidence, the Government based its argument to the jury that appellant was predisposed to sell non-tax-paid liquor. This evidence would not even be sufficient to establish that the agent had good cause to suspect appellant (assuming that is a relevant inquiry), let alone competent to show that appellant possesses the requisite guilty intent. If in fact appellant has a reputation in the community for dealing in moonshine, that should be simple enough for the Government to establish in the usual fashion on retrial . . . .[226]

C. *Informers*

A significant number of entrapment decisions have concerned the status of informers. It is now well established that both paid and unpaid informers are government agents if they act on behalf of the government in inducing the commission of a crime.[227] Persons acting in a personal or private capacity, however, cannot be entrappers.[228] Thus, an accomplice who agrees to testify for the government after being caught is not a government agent for purposes of the entrapment defense,[229] and the government is not guilty of entrapment even if the cooperating witness induced another defendant to join in the criminal act.[230] Courts have also refused to apply the entrapment doctrine when the alleged entrapper was a private citizen or a private detective.[231]

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[226] *Id.* at 752; *accord*, United States v. Hairrell, 521 F.2d 1264, 1267-68 (6th Cir.), *cert. denied*, 96 S. Ct. 568 (1975).

[227] *See, e.g.*, Sherman v. United States, 356 U.S. 369, 373 (1958); United States v. Waddell, 507 F.2d 1226, 1228 (5th Cir.1975); Notaro v. United States, 363 F.2d 169 (9th Cir. 1966).

[228] Notaro v. United States, 363 F.2d 169, 172 n.2 (9th Cir. 1966); Johnson v. United States, 317 F.2d 127, 128 (D.C. Cir. 1963); Henderson v. United States, 237 F.2d 169, 175 (5th Cir. 1957).

[229] United States v. Koss, 506 F. 2d 1103, 1112 (2d Cir. 1974), *cert. denied*, 420 U. S. 977 (1975); *see* United States v. Register, 496 F.2d 1072 (5th Cir. 1974), *cert. denied*, 419 U.S. 1120 (1975). An early commentator tried to clarify the differences in the types of entrappers. The author identified four classes of persons who assist the police: informants, spies, stool pigeons, and agent provocateurs, the latter two being varieties of entrappers. *See* Donnelly, *supra* note 3, at 1092-93. Unfortunately, this terminological precision has never been adopted by the courts.

[230] United States v. Koss, 506 F.2d 1103 (2d Cir. 1974), *cert. denied*, 420 U.S. 977 (1975); United States v. Conversano, 412 F.2d 1143 (3d Cir.), *cert. denied*, 396 U. S. 905 (1969).

[231] United States v. Mayo, 498 F.2d 713 (D.C. Cir. 1974); United States v. Maddox, 492 F.2d 104 (5th Cir.), *cert. denied*, 419 U.S. 851 (1974); United States v. Laverick, 348 F.2d 708 (3d Cir.), *cert. denied*, 382 U.S. 940 (1965).

On some occasions, the federal courts have criticized, implicitly or explicitly, the government's failure to call an informer as a prosecution witness.[232] Nonetheless, there is no general requirement that the government call the informer as a witness.[233] The courts have also approved the use of government funds to pay informers and finance their activities.[234]

The sixth amendment right of confrontation requires the government to identify informers in some cases,[235] but the courts of appeals have refused to adopt a blanket rule on this issue. The Fifth Circuit affirmed a conviction despite a claim that failure to identify an informer precluded the defendant from presenting an entrapment defense at trial. The court rejected the contention because the "defendant, by hypothesis, knew whatever, if anything, the informer had said or done to entrap," and, therefore, he could not "plead ignorance or inability to supply the missing substantiation."[236] The Fifth Circuit has also refused to require revelation of an informer's address despite defense reliance on entrapment.[237] Similarly, the Tenth Circuit has affirmed the denial of an order for the production of an informer where the government denied knowledge of his whereabouts,[238] and the Sixth Circuit has ruled that failure to disclose an informer's identity was "not erroneous" where "the proof approached establishing of predisposition as a matter of law."[239]

D. Alternate Defenses

Although *Sorrells*, the first Supreme Court decision on entrapment,

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[232] *See, e.g.*, United States v. Bueno, 447 F.2d 903, 906 (5th Cir. 1971), *cert. denied*, 411 U.S. 949 (1973); cf. United States v. Anglada, 524 F.2d 296, 300 (2d Cir. 1975); United States v. Waddell, 507 F.2d 1226, 1228 (5th Cir. 1975); United States v. Gomez-Rojas, 507 F.2d 1213, 1218 (5th Cir.), *cert. denied*, 423 U.S. 826 (1975). *See generally* Orfield, *supra* note 69, at 61-62.

[233] *See* United States v. Masciale, 356 U.S. 386, 388 n.4 (1958); United States v. Dovalina, 525 F.2d 952, 955-56 (5th Cir. 1976); United States v. Trent, 284 F.2d 286, 289 (D.C. Cir. 1960), *cert. denied*, 365 U. S. 889 (1961); United States v. Washington, 275 F.2d 687, 690 (5th Cir. 1960); *cf.* United States v. Eddings, 478 F.2d 67 (6th Cir. 1973)(failure to reveal informer's identity is harmless error).

[234] United States v. Jett, 491 F.2d 1078, 1081 (1st Cir. 1974); United States v. Cuomo, 479 F.2d 688 (2d Cir.), *cert. denied*, 414 U.S. 1002 (1973). *But cf.* United States v. Johnson, 317 F.2d 127, 128 (D.C. Cir. 1963). *See also* United States v. Landley, 517 F.2d 1190 (9th Cir. 1975)(payment of informer); United States v. Spivey, 508 F.2d 146 (10th Cir.), *cert. denied*, 421 U.S. 949 (1975) (payment of informer).

[235] *See* Roviaro v. United States, 353 U.S. 53 (1957); *cf.* United States v. Gomez-Rojas, 507 F.2d 1213 (5th Cir.), *cert. denied*, 423 U.S. 826 (1975) (informer's refusal to answer question because of fifth amendment right against self-incrimination must be scrutinized by trial court).

[236] United States v. Hodges, 493 F.2d 11, 12 (5th Cir. 1974).

[237] United States v. McKinley, 493 F.2d 547 (5th Cir. 1974).

[238] United States v. Hayes, 477 F.2d 868, 871 (10th Cir. 1973).

[239] United States v. Eddings, 478 F.2d 67 (6th Cir. 1973).

expressly rejected the government's position that entrapment was an affirmative defense not available on a not-guilty plea,[240] the lower federal courts have generally failed to follow the Supreme Court precedent. A plethora of cases have refused to allow a defendant to raise the defense when the defendant has testified to his innocence of the charge or otherwise denied the crime.[241] For example, the Fifth Circuit held that a defendant who took the witness stand to deny knowledge or involvement in the drug transfer with which he was charged could not raise an entrapment defense. Terming his testimony "utterly inconsistent with the theory that he was entrapped into supplying the [drug]," the court applied "the settled law of this Circuit that a defendant can not deny he had committed the offense and rely on the inconsistent defense of entrapment."[242]

Some cases have gone so far as to require the defendant to make an affirmative admission of the offense with which he is charged before allowing him to assert entrapment. An extreme expression of this position is *United States v. Mitchell*.[243] In *Mitchell*, the defendant was convicted of endeavoring to intimidate a witness in a criminal case. The defendant admitted that he had accepted money from an informer, but denied that he ever intended to kill the witness as the informer claimed. Even though the Sixth Circuit recognized that entrapment of Mitchell was a possible interpretation of certain taped conversations between the accused and the informer, it held that "the district judge properly precluded [Mitchell] from relying on the defense of entrapment."[244]

As the foregoing discussion indicates, most decisions have pre-

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[240] Sorrells v. United States, 287 U.S. 435, 452 (1932). The modern rules of criminal procedure, which allow only pleas of guilty, not guilty, and nolo contendere, have eliminated the plea in bar for affirmative defenses. See FED. R. CRIM. P. 11, 12. *See also* Murchison, *supra* note 1, at 232.

[241] *See, e.g.*, United States v. Mitchell, 514 F.2d 758 (6th Cir.), *cert. denied*, 423 U.S. 847 (1975); United States v. Rodriguez, 498 F.2d 302 (5th Cir. 1974); United States v. Badia, 490 F.2d 296 (1st Cir. 1973); United States v. Watson, 489 F.2d 504 (3d Cir. 1973); United States v. Smaldone, 484 F.2d 311 (10th Cir.), *cert. denied*, 415 U.S. 1079 (1973); United States v. Ramirez, 482 F.2d 807 (2d Cir.), *cert. denied*, 414 U.S. 1070 (1973); United States v. Williamson, 482 F.2d 508 (5th Cir. 1973); United States v. Kilpatrick, 477 F.2d 357 (6th Cir. 1973); United States v. Gibson, 446 F.2d 719 (10th Cir. 1971); Munroe v. United States, 424 F.2d 243 (10th Cir. 1970); Sylvia v. United States, 312 F.2d 145 (1st Cir.), *cert. denied*, 374 U.S. 809 (1963). For a further collection of cases, see United States v. Shameia, 464 F.2d 629, 630-32 (6th Cir. 1972), *cert. denied*, 409 U.S. 1076 (1973); *cf.* United States v. Posey, 501 F.2d 998, 1002 (6th Cir. 1974) ("We are then confronted by the defense . . . of entrapment . . . an unusual defense in that [appellant] claims he was entrapped into violating a law, that he also claims he did not violate in the first place.").

[242] United States v. Williamson, 482 F.2d 508, 515 (5th Cir. 1973).

[243] 514 F.2d 758 (6th Cir.), *cert. denied*, 423 U.S. 847 (1975).

[244] *Id.* at 761.

cluded assertion of the entrapment defense when the defendant asserts his innocence, but the law is much less uniform than these opinions intimate. In the first place, many of the statements can be dismissed as dicta inasmuch as the courts also asserted an independent basis for denying the claim—either that the evidence was insufficient to submit the defense to the jury[245] or that the defendant had not raised the entrapment defense until his appeal.[246] Moreover, even before *Russell*, two circuits had expressly approved of alternate defenses of entrapment and innocence,[247] and other circuits have fashioned exceptions to permit the assertion of alternate defenses in particular cases.

As early as 1956, the Fifth Circuit approved the assertion of alternate defenses in *Henderson v. United States*.[248] Some later opinions attempted to distinguish *Henderson* into oblivion,[249] but the attempt has not been entirely successful and the court has allowed alternate defenses in other cases.[250] Similarly, the First Circuit has occasionally permitted alternate defenses,[251] and the Sixth Circuit's recent decision in *Ambrose v. United States*,[252] suggests that *Russell* will not deter future exceptions. The Ninth Circuit recently abandoned a long line of cases refusing to allow alternate entrapment defenses,[253] and ruled, en

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[245] *E.g.*, United States v. Badia, 490 F.2d 296 (1st Cir. 1973); United States v. Ramirez, 482 F.2d 807 (2d Cir.), *cert. denied*, 414 U.S. 1070 (1973).

[246] *E.g.*, United States v. Rodriguez, 498 F.2d 302 (5th Cir. 1974); United States v. Williamson, 482 F.2d 508 (5th Cir. 1973).

[247] Hansford v. United States, 303 F.2d 219 (D.C. Cir. 1962); Crisp v. United States, 262 F.2d 68, 70 (4th Cir. 1958).

[248] 237 F.2d 169 (5th Cir. 1956).

[249] Beatty v. United States, 377 F.2d 181 (5th Cir.), *rev'd on other grounds*, 389 U.S. 45 (1967); *cf.* United States v. Newcomb, 488 F.2d 190 (5th Cir. 1974).

[250] Sears v. United States, 343 F.2d 139, 143 (5th Cir. 1965).

[251] United States v. Rodrigues, 433 F.2d 760 (1st Cir. 1970), *cert. denied*, 401 U.S. 943 (1971); Gorin v. United States, 313 F.2d 641 (1st Cir. 1963).

[252] 483 F.2d 742 (6th Cir. 1973). In *Ambrose*, an undercover agent testified that Ambrose approached him to ask if he had seen a third party, that he expressed a desire to purchase liquor from Ambrose, that Ambrose told him to come to a local restaurant that night, that Ambrose and an accomplice named Luke delivered the liquor, and that the agent paid Luke for the liquor. Testifying in his own behalf, Ambrose denied that he had arranged the sale. He admitted, however, that he introduced the agent to Luke and that he was present in the restaurant when the agent arrived to buy the liquor. The court rejected the government's assertion that an earlier decision, United States v. Shameia, 464 F.2d 629 (6th Cir. 1972) (holding "that a defendant who does not admit to having performed every act necessary to the commission of the offense charged may not raise the defense of entrapment") precluded Ambrose from relying on the defense. The court held that Ambrose's admission that he brought together the agent and Luke "constituted a sufficient admission of his participation . . . regarding the circumstances of the meeting at the restaurant on the night of October 1." *Id.* at 752 n.6.

[253] *See, e.g.*, United States v. Thompson, 493 F.2d 305 (9th Cir. 1974); United States v. Baxter, 492 F.2d 150 (9th Cir. 1973), *cert. denied*, 416 U.S. 940 (1974); United States

banc, that it will allow alternate defenses in the future.[254] The court gave three reasons for its change in position: the conflict of its prior position with Supreme Court authority, the inability to justify previous applications of the rule on the basis of the inconsistency theory, and the infirmity of the inconsistency theory itself.[255]

CONCLUSION

The current status of federal law on entrapment may be appropriately characterized as confused.[256] The Supreme Court's reaffirmance of the subjective test based on statutory construction in *Russell*, recently reiterated in *Hampton*, has continued, if not exacerbated, the confusion. In post-*Russell* cases, the courts of appeals have split over most significant issues concerning the doctrine. Although post-*Russell* opinions paid lip service to the focus on predisposition, the pre-*Hampton* experience was far from uniform. Three circuits recognized the defense, or one strikingly similar to it, based solely on governmental conduct in certain limited situations. There was also a division among the circuits over the issues of the burden of proof, the evidence that is admissible to prove predisposition, the government's relation with its informers, and the permissibility of alternative defenses of entrapment and innocence.

As far as *Russell* is concerned, the majority's decision not to elevate entrapment to a constitutional defense was a sound one. In view of the widely divergent results the defense has produced in 60 years of federal litigation, hardening the defense into a constitutional dogma binding on the states would be unwise. Moreover, if the federal cases are a reliable guide, it would unleash a flood of appeals from state convictions for a defense that would normally turn on factual questions.

On the other hand, Mr. Justice Rehnquist's rationale for refusing to reconsider the nonconstitutional basis for entrapment in *Russell* is unpersuasive, and the adherence to *Russell* in *Hampton* added nothing to the substance of the argument. The *Russell* argument that "*Sorrells* is a precedent of long standing . . . already . . . once reexamined in

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v. Noah, 475 F.2d 688 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); United States v. Hendricks, 456 F.2d 167 (9th Cir. 1972); Ortiz v. United States, 358 F.2d 107 (9th Cir. 1966); Ortega v. United States, 348 F.2d 874 (9th Cir. 1965); Ramirez v. United States, 294 F.2d 277 (9th Cir. 1961); Brown v. United States, 261 F.2d 848 (9th Cir. 1958); Eastman v. United States, 212 F.2d 320 (9th Cir. 1954).

[254] United States v. Demma, 523 F.2d 981 (9th Cir. 1975).

[255] *Id.* at 982.

[256] *Id.* "The law of entrapment in this circuit is confused and conflicting. Our cases can be reconciled neither with each other nor with [the Supreme Court cases]." *Id.*; *accord*, Note, *supra* note 41. The confusion is not a recent phenomenon. *See* Kadis v. United States, 373 F.2d 370, 372 (1st Cir. 1967); Donnelly, *supra* note 3, at 1103.

Sherman and implicitly there reaffirmed,"[257] misrepresents the nature of the earlier decisions. In recognizing the defense of entrapment, *Sorrells* advanced a new theory that had not been advanced by either party or expressed in any prior decisions of a lower court. In addition, the Court carefully limited its statutory construction argument to the National Prohibition Act, a statute whose repeal was inevitable by the time of the *Sorrells* decision.[258] *Sherman* broadened *Sorrells* to a general principle of statutory construction but declined to reconsider the theory of the defense because the parties in *Sherman* had not briefed or argued the issue.[259] *Russell* then declined to overrule the earlier cases because one was a precedent of long standing which the other had implicitly reaffirmed. A skeptical restatement of the majority's argument might read: The Court declined to reconsider the defense because long ago it concocted a new, untested theory that had not been suggested by either party, and the parites in a subsequent case did not ask the Court to overrule the theory the Court originally developed on its own motion.[260] The *Hampton* plurality carried the subjective test one step further in completely negating the governmental conduct element of the defense. Perhaps the next logical step for the government would be to repeat the prohibition enforcement tactic[261] by opening a heroin distribution service that will sell openly to all comers.

Perhaps the most pragmatic justification for the majority's refusal to reconsider *Sorrells* and *Sherman* is that they do not withstand critical analysis well. *Sorrells* is best understood as a pragmatic, narrow decision that was justified by the forthcoming repeal of the statute that had encouraged the growth of the entrapment defense in the first place. *Sherman* and *Masciale* can only be defended on the ground that they were responsive to the arguments of the litigants involved. Neither provided such strong precedent as to preclude reconsideration by the Court. Moreover, the majority's two criticisms of the objective approach are not particularly cogent. Cases such as *Lewis v. United States*[262] belie the unsupported assertion that focusing on police conduct alone would pre-

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[257] United States v. Russell, 411 U.S. 423, 433 (1973).

[258] See Murchison, *supra* note 1, at 231, 235-36.

[259] Sherman v. United States, 356 U.S. 369, 376 (1958). *See also* United States v. Masciale, 356 U.S. 386, 388 n.5 (1958).

[260] The Court's implicit logic calls to mind one of Mr. Justice Holmes' observations:

> It is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV. It is still more revolting if the grounds upon which it was laid down have vanished long since, and the rule simply persists from blind imitation of the past.

Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

[261] *See* Murchison, *supra* note 1, at 212.

[262] 385 U. S. 206 (1966).

clude conviction for offenses that occur in secret. Furthermore, the majority's declaration that it is not "particularly desirable"[263] to allow a predisposed defendant to go free because of improper police conduct is, at best, an unsupported value judgment that begs the question.

Set against these two arguments, numerous objections to the subjective approach have been advanced by judges and scholars. The fictional basis of the statutory construction argument is an obvious, initial deficiency,[264] and it is difficult to support a legal fiction that has produced the confused results of the subjective approach. In addition, proponents of the objective test have correctly identified the misleading implications of the term "otherwise innocent."[265] They have noted that focusing on predisposition makes the traditional distinction between entrapment by a private citizen and entrapment by a government agent a tenuous one because it is hard to see how the defendant's blameworthiness is affected by the status of the person who entraps him.[266] They have also indicated the dangers of prejudice inherent in the evidence used to prove predisposition,[267] and they have called attention to the equal protection implication of allowing a defendant to be judged on his past record.[268]

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[263] United States v. Russell, 411 U.S. 423, 434 (1973).

[264] *Id.* at 441-42 (Stewart, J., dissenting); Sherman v. United States, 356 U.S. 369, 379 (1958)(Frankfurter, J., concurring). *See also* Donnelly, *supra* note 3, at 1110.

[265] United States v. Russell, 411 U.S. 423, 442 (1973); *cf.* Donnelly, *supra* note 3, at 1107.

> There is a strange confusion of thought in the "genesis of intent" formula. When a court declares that the defendant is entitled to an acquittal if the offense was conceived and planned by the officer, what offense is the court talking about? If it is referring to the offense for which the defendant is on trial then, in practically every case, *that* particular offense was conceived and planned by the officer and would not have taken place except for the conduct of the latter. . . . The defendant may have committed similar offenses in the past but he is not on trial for them. Obviously, there is insufficient evidence of his prior violations to convict him otherwise it would have been unnecessary to entrap him in the immediate transaction. Nor is he on trial for uncommitted offenses. The offense for which he is on trial is certainly one that he would not have committed if it had not been "conceived and planned" by the officer nor would the defendant have committed it "except for the trickery, persuasion or fraud of the officer." If the courts really meant what they say, a defendant could never be convicted in these police-induced cases.

Id. (footnotes omitted).

[266] *See* United States v. Russell, 411 U.S. 423, 442 (1973) (Stewart, J., dissenting).

[267] *See id.* at 443-44; Sherman v. United States, 356 U.S. 369, 382 (1958)(Frankfurter, J., concurring); Sorrells v. United States, 287 U.S. 435, 459 (1932)(Roberts, J., separate opinion).

[268] *See* Sherman v. United States, 356 U.S. 369, 383 (1958) (Frankfurter, J., concurring); *cf.* Hampton v. United States, 96 S. Ct. 1646, 1652 n.7 (1976) (Powell, J., concurring).

More importantly, the statutory construction approach does not appear to reflect the true basis of the decided cases. The concurring opinion in *Hampton* demonstrates that a majority voted for *Hampton's* affirmance only because the concurring justices approved of the police tactics involved.[269] Mr. Justice Rehnquist's essay in *Russell*[270] on the "illegal enterprise" of manufacturing drugs indicates that the decision is based in large part on similar rationale. Correspondingly, Mr. Justice Frankfurter termed it "clear" that the true reason for the *Sherman* reversal was the Court's objection to the informer's conduct,[271] and a close reading of the majority opinion suggests that the observation was correct.[272] A similar conclusion seems appropriate for most of the lower court entrapment cases, especially reversals, which are more easily explained in terms of appraisals of governmental conduct than in terms of predisposition.[273] One of the results of the failure to directly confront

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[269] *See* Hampton v. United States, 96 S. Ct. 1646, 1652 n.7 (1976) (Powell, J., concurring).

[270] United States v. Russell, 411 U.S. 423, 431-32 (1973).

[271] Sherman v. United States, 356 U.S. 369, 383 (1958) (Frankfurter, J., concurring).

[272] *Id.* at 376 (majority opinion). "Law enforcement does not require methods such as this." *Id.*

[273] *See, e.g.*, United States v. Oquendo, 490 F.2d 161 (5th Cir. 1974); Greene v. United States, 454 F.2d 783 (9th Cir. 1971); United States v. Bueno, 447 F.2d 903 (5th Cir. 1971), *cert. denied*, 411 U.S. 949 (1973); Williamson v. United States, 311 F.2d 441 (5th Cir. 1962); Wall v. United States, 65 F.2d 993 (5th Cir. 1933); O'Brien v. United States, 51 F.2d 674 (7th Cir. 1931); Driskill v. United States, 24 F.2d 525 (9th Cir. 1928); Butts v. United States, 273 F. 35 (8th Cir. 1921); Woo Wai v. United States, 223 F. 412 (9th Cir. 1915).

Professor Goldstein offers an especially penetrating criticism of the subjective approach. He attacks the focus on predisposition because it requires that the judicial machinery make psychological judgements for which it lacks competence. *See* Goldstein, *For Harold Lasswell: Some Reflections on Human Dignity, Entrapment, Informed Consent, and the Plea Bargain*, 84 YALE L.J. 683 (1975). He argues that

> [i]n making crucial a distinction between the citizen who is presumed innocent and the citizen who is presumed criminal, the Court [has lost] sight of the primary purpose of the entrapment doctrine: to control the authorities and to hold them to a standard of fairness in relation to all persons.

Id. at 687. Treating the problem as merely one manifestation of a larger need for the criminal law to promote human dignity, he summarizes his argument for an objective approach in the following manner:

> The law must establish standards of conduct for the authorities, not for the citizens, in these transactions. The rules should force supervising agents to focus (primarily, if not exclusively) on the appropriateness of the authorities' conduct in communicating with the citizens concerned and in manipulating the settings in which decisions to consent are obtained. The priority of attention for inquiry would thereby be shifted from more subjective to more objective concerns, from the consenting citizen's state of knowledge and understanding to the conduct of the authorities in the process of informing the citizen for decision. Whether the citizen actually gave or denied consent would not be relevant to the inquiry.

the true basis of the entrapment defense has been continued inconsistency in lower court decisions. Moreover, it gave *Russell* little permanence for it could easily be distinguished as commentary,[274] and decisions of the courts of appeals[275] confirmed this. Only time will tell if the three-way split of *Hampton* has laid to rest the 60-year dispute. Mr. Justice Frankfurter's thoughtful critique in *Sherman* remains applicable:

> Today's opinion does not promote the judicial desideratum, and fails to give the doctrine of entrapment the solid foundation that the decisions of the lower courts and criticism of learned writers have clearly shown is needed. Instead it accepts without re-examination the theory espoused in *Sorrells* . . . . The fact that since the *Sorrells* Case the lower courts have either ignored its theory and continued to rest decision on the narrow facts of each case, or have failed after penetrating effort to define a satisfactory generalization . . . is proof that the prevailing theory of the *Sorrells* Case ought not to be deemed the last word. In a matter of this kind the Court should not rest on the first attempt at an explanation . . . . It should not forego re-examination to achieve clarity of thought, because confused and inadequate analysis is too apt gradually to lead to a course of decisions that diverges from the true ends to be pursued.[276]

Thus logic suggests the need for reconsideration of the subjective approach. Unfortunately, the Court's recent decisions in *Russell* and *Hampton* make it unreasonable to hope for a judicial solution. Congress, however, will have a chance to reconsider the defense as it deliberates on the proposed Federal Criminal Code, and perhaps logic and reason will yet prevail. In the meantime, however, one must attempt to fashion a coherent statement of the current doctrine to guide lawyers and courts in reasonably logical application of the defense.

The problem first encountered is determining a standard for judicial findings of entrapment as a matter of law. In light of *Hampton*, the courts of appeals can be expected to continue the post-*Russell* limits on the governmental involvement aspect of the defense. The court, however, might still refuse to extinguish the concept altogether. Judge

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> What would be critical to a finding that the state's commitment to human dignity was served or disserved would be the authority's conduct in light of the more objective standards set.

Id. at 686.

[274] *See, e.g.*, Comment, *Elevation of Entrapment to a Constitutional Defense*, 7 U. MICH. J.L. REF. 361, 384 (1974); 59 CORNELL L. REV. 546, 564 (1974); 87 HARV. L. REV. 243, 249-51 (1973); 59 MINN. L. REV. 444, 454 (1974).

[275] *See* notes 174 through 179 and accompanying text *supra*.

[276] Sherman v. United States, 356 U.S. 369, 378-79 (1958) (Frankfurter, J., concurring) (footnotes omitted).

Friendly, speaking for the Second Circuit in an opinion which the concurring justices in *Hampton* cited with approval, expressly retained the prerogative to say that, at some point, governmental misconduct becomes "too much" to allow the prosecution to continue.[277] Although the Supreme Court has rejected the opinion of two circuits that identified the informer-supplier, agent-purchaser arrangement as involving such misconduct,[278] a majority of the Court would still recognize the possibility that a court might permit the defense in certain unspecified situations. Evaluation of these decisions admittedly turns on a value judgment as to how reprehensible one regards the particular conduct, and the Supreme Court's refusal to directly address the governmental conduct issue in its entrapment decisions means that lower courts have little guidance on this crucial issue.

The burden of proof issue is one on which the Supreme Court has given no clear guidance to direct the lower courts. Of the two tests applied in the various circuits,[279] the unitary test of the First Circuit seems preferable. The unitary approach avoids the metaphysical abstractions of shifting burdens and varying quantums of proof. It is, therefore, more likely to serve as a comprehensible explanation to the jury of the central issue they must address; that is, is the government responsible for the criminal conduct of this defendant?

Since the Supreme Court has reaffirmed the subjective test in *Russell*, the defendant is still subject to the "appropriate and searching inquiry"[280] of his predisposition which *Sorrells* authorized. In applying the *Sorrells* standard, however, the courts should recognize that it has two elements: The inquiry must be appropriate as well as searching. Recent Fifth Circuit decisions admitting reputation evidence from one with only the most tenuous connections to the community in which the defendant has established his reputation appear to have ignored the requirement of appropriateness, especially in view of the high likelihood of prejudice.[281] The decisions of the Sixth Circuit are better reasoned in requiring the government, if it desires to introduce reputation evidence, to meet "the requirements ordinarily imposed upon the introduction of [such] evidence."[282]

Use of informers creates a fourth problem area under the subjective

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[277] United States v. Archer, 486 F.2d 670, 677 n.6 (2d Cir. 1973), *quoting* Williamson v. United States, 311 F.2d 441, 445 (5th Cir. 1962) (Brown, J., concurring).

[278] *See* United States v. West, 511 F.2d 1083, 1085 (3d Cir. 1975); United States v. Oquendo, 490 F.2d 161 (5th Cir. 1974).

[279] *See* notes 200 through 211 and accompanying text *supra*.

[280] Sorrells v. United States, 287 U.S. 435, 451-52 (1932).

[281] *See* notes 221 through 223 and acompanying text *supra*.

[282] United States v. Ambrose, 483 F.2d 742, 752 (6th Cir. 1973).

entrapment defense. As the Supreme Court minorities have consistently pointed out, focusing on the predisposition of the defendant makes it difficult to rationalize the limitation of the defense to official agents. The lower courts have, however, consistently imposed the limitation, probably on the pragmatic rationale that recognizing entrapment by private citizens would expand the defense to unmanageable proportions. One can imagine, for example, one or more defendants asserting the defense in almost every conspiracy case. The courts have also wisely followed a pragmatic course with respect to informer identity. They have acknowledged the defendant's right to the disclosure of the identity when asserting a defense based on an informer's entrapment, but they have required some showing by the defense that it needs the testimony of the informer before ordering disclosure.

The lower court decisions disapproving assertion of alternate defenses of entrapment and innocence conflict directly with the Supreme Court's decision in *Sorrells*. As the majority opinion in *Sorrells* acknowledged,[283] the government's principal contention in that case was that entrapment was an affirmative defense unavailable to a defendant on a plea of not guilty. The Supreme Court squarely rejected that argument. Notwithstanding *Sorrells*, lower court decisions still include statements that entrapment is an affirmative defense and regularly refuse to allow defendants to assert alternate defenses of entrapment and innocence.[284] Some even go so far as to hold that a defendant cannot raise the defense unless he admits the offense with which he is charged, thereby denying the defense to a defendant who elects not to testify.[285]

In addition to precedent, sound reasoning dictates that courts should allow alternate defenses. The government has the burden of proof on both issues, and courts should not require the defendant to waive his right to have the government prove his guilt merely because questionable government tactics raise an entrapment defense. Commentators have long advocated permitting the defendant to assert alternate defenses,[286] and the Ninth Circuit's recent decision to allow alternate defenses[287] lends hope that the scholarly literature may finally be influencing judicial decisions.

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[283] Sorrells v. United States, 287 U.S. 435, 452 (1932).

[284] *See* notes 240 through 242 and accompanying text *supra*.

[285] *See* notes 243 & 244 and accompanying text *supra*.

[286] *See, e.g.*, Groot, *The Serpent Beguiled Me and I (Without Scienter) Did Eat—Denial of Crime and the Entrapment Defense*, 1973 U. ILL. L.F. 254; Note, *Entrapment*, 73 HARV. L. REV. 1333 (1960); Comment, *The Assertion of Inconsistent Defenses in Entrapment Cases*, 56 IOWA L. REV. 686 (1971); 70 HARV. L. REV. 1302 (1957).

[287] United States v. Demma, 523 F.2d 981 (9th Cir. 1975). *But see* United States v. O'Leary, 529 F.2d 1202 (5th Cir. 1976) (per curiam).

Of course, permitting alternate defenses does not mean that all defendants are entitled to submit the defense of entrapment to the jury; they are entitled to submit it only when the jury could reasonably find that the evidence established entrapment. As many of the cases refusing to allow alternate defenses have indicated, the evidence would seldom raise such a defense when the defendant remained silent or testified that he was innocent. In the minority of cases when the evidence does reasonably raise the defense, the issue should be submitted to the jury, as several courts have apparently recognized in devising exceptions to the general prohibition against alternate defenses.[288] The better practice—or at least one that will promote uniformity—is to recognize the principle of alternate defenses when raised by the evidence rather than relying on ad hoc exceptions to meet individual cases.

Finally, the whole of the story of entrapment serves as a study in microcosm of the federal legal system. Because the federal government, like most states, has followed the English model rather than that of the civil law countries, much American law is judge-made. Moreover, the dual appellate system of the federal system allows the federal circuits a creative role in fashioning new doctrines or applications so that the Supreme Court has the opportunity to look at the ramifications of the judge-made law before reaching a final decision. Notwithstanding the common law genesis of much of our law, the judiciary is often hesitant to refashion theories in light of changing circumstances, and so legislatures often have to provide some guidance. As Part I of this study indicated,[289] entrapment developed during the era of national prohibition, and its early development reflected the influence of prohibition. Despite the passage of national prohibition from the scene and the typical application of entrapment to other cases, the Supreme Court has consistently declined a systematic reconsideration of the rule. The historical circumstances have changed, but the attitudes the earlier circumstances engendered remain. To paraphrase Mr. Justice Holmes: The reason for the rule disappears; the rule remains.[290]

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[288] *See* notes 247 through 255 and accompanying text *supra*.

[289] Murchison, *supra* note 1.

[290] A very common phenomenon, and one very familiar to the student of history, is this. The customs, beliefs, or needs of a primitive time establish a rule or a formula. In the course of centuries the custom, belief, or necessity disappears, but the rule remains. The reason which gave rise to the rule has been forgotten, and ingenious minds set themselves to inquire how it is to be accounted for. Some ground of policy is thought of, which seems to explain it and to reconcile it with the present state of things; and then the rule adapts itself to the new reasons which have been found for it, and enters on a new career. The old form receives a new content, and in time even the form modifies itself to fit the meaning which it has received.

O.W. Holmes, The Common Law 5 (1923).

MEDICAL MALPRACTICE IMMUNITY: A REALISTIC PROGNOSIS FOR THE SOCIAL SECURITY ACT'S CIVIL IMMUNITY PROVISION

*Robert F. Carter**

Confronted with crises regarding the availability and cost of medical malpractice insurance, state legislators in recent months have tinkered furiously with procedural and substantive law, producing numerous changes designed to streamline and rationalize the determination of liability and to lower the cost of compensation in medical malpractice cases.[1] A new and relatively obscure federal statute,[2] promises to emerge as a critical factor in the determination of liability in medical malpractice cases, notwithstanding the requirements of state law. This statute, as yet judicial *terra incognita* is intended to provide freedom from civil liability on many medical malpractice claims for both professional and institutional health care providers who comply with, or rely upon, professional standards of diagnosis and treatment supplied by local Professional Standards Review Organizations (PSRO).[3] Applied with restraint and care, this immunity provision should aid in the resolution of many malpractice disputes; but misinterpretation of this statute could induce much senseless litigation and greatly inhibit the exercise of sound medical judgment.

I. PSRO: The Immunity Provision in Context

As part of the Social Security Amendments of 1972, Congress mandated the development of PSRO's. These groups, initially composed of local physicians, are to review cases in which federal reimbursement is sought for the costs of medical services.[4] Out of the 203 local PSRO areas

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[1] *See, e.g.*, Mich. Comp. Laws Ann. §§ 600.5033, .5040 to .5059, .5065 (Supp. 1976); Tenn. Code Ann. §§ 23-3401 to -3421 (Supp. 1975); Wis. Stat. Ann. §§ 298.04, 298.04(2), 655.001 to .27 (Spec. Pamphlet 1975). For a discussion of the increasingly significant state legislation concerning medical malpractice see Miike, *State Legislators Address the Medical Malpractice Situation*, 3 J. Legal Med. 25 (1975).

[2] 42 U.S.C. § 1320c-16(c) (Supp. IV, 1974).

[3] The statute is designed to place emphasis upon the application of review by professional peers. *See* 42 U.S.C. §§ 1320c to 1320(c)-19 (Supp. IV, 1974).

[4] *Id.*

in the United States specified by the Secretary of Health, Education, and Welfare (HEW),[5] 65 are now designated as "conditional" and are performing, on a trial basis, many of the review functions for which they are designed.[6] Approximately 50 PSRO's will become fully operational during the 1976-77 fiscal year. An additional 55 PSRO's, many of which will soon enter "conditional" status, are now in the official planning stage and some planning activity is proceeding in virtually all PSRO areas.[7]

The fully operational PSRO will act as the agent of the Secretary of HEW in determining whether claims for reimbursement for medical care should be paid under the Social Security Act. In performing this function, PSRO's are required to determine whether the services rendered, as well as medicine and other physical items purchased, were (1) "medically necessary," (2) met "professionally recognized standards of health care," and (3) were delivered in the least expensive manner.[8] The theory underlying the statute is that the local physicians who comprise the PSRO will know what constitutes good medical practice in their locality and will thus be fit to decide whether the health care practitioner or institution performed in adequate compliance with local standards of practice for purposes of federal reimbursability.[9]

Difficult or unusual cases must be examined individually to determine whether the medical services and items delivered were necessary and met professional standards of quality.[10] The federal statutory scheme, however, calls for the development of a body of written "professional standards,"[11] against which individual conduct will be measured. The statute provides:

> (a) Each Professional Standards Review Organization shall apply professionally developed norms of care, diagnosis, and treatment based upon typical patterns of practice in its regions (including typical lengths-of-stay for institutional care by age and diagnosis) as principal points of evaluation and review . . . .
> (b) Such norms with respect to treatment for particular illnesses or

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[5] OFFICE OF PROFESSIONAL STANDARDS REVIEW, U.S. DEP'T OF HEALTH, EDUCATION, AND WELFARE, PSRO PROGRAM MANUAL § 204.4, at 29 (1974) [hereinafter cited as PROGRAM MANUAL].

[6] Telephone Interview with Dr. John Ball, Office of Professional Standards and Review, United States Dep't of Health, Education, and Welfare, Rockville, Md., May 18, 1976.

[7] *Id.*

[8] 42 U.S.C. § 1320c-4(a)(1) (Supp. IV, 1974).

[9] *See id.*; S. REP. No. 1230, 92d Cong., 2d Sess. 254-69 (1972) [hereinafter cited as S. REP. No. 1230].

[10] *See* PROGRAM MANUAL, *supra* note 5, § 701, at 1-4.

[11] 42 U.S.C. § 1320c-5 (Supp. IV, 1974).

health conditions shall include (in accordance with regulations of the Secretary)

(1) the types and extent of the health care services which, taking into account differing, but acceptable, modes of treatment and methods of organizing and delivering care are considered within the range of appropriate diagnosis and treatment of such illness or health condition, consistent with professionally recognized and accepted patterns of care;

(2) the type of health care facility which is considered, consistent with such standards, to be the type in which health care services which are medically appropriate for such illness or condition can most economically be provided.[12]

The statute further provides that where local PSRO norms are different from "regional" norms, the local PSRO may be required to use the regional norms as a basis for determining federal reimbursability.[13] Thus exists a mechanism for pressing change in practice standards upon local health care providers. This mechanism, given the acrimonious opposition to the PSRO's by many physicians who fear that their good judgment may be severely impinged upon by federal "cookbook" medicine,[14] is likely to remain unused.

A. The Immunity Provision

In order to promote acceptance of the PSRO's "professionally recognized standards of health care," Congress provided that

No doctor of medicine or osteopathy and no provider (including directors, trustees, employees, or officials thereof) of health care services shall be civilly liable to any person under any law of the United States or of any State (or political subdivision thereof) on account of any action taken by him in compliance with or reliance upon professionally developed norms of care and treatment applied by a Professional Standards Review Organization . . . operating in the area where such doctor of medicine or osteopathy or provider took such action but only if

(1) he takes such action (in the case of a health care practitioner) in the exercise of his profession as a doctor of medicine or osteopathy (or in the case of a provider of health care services) in the exercise of his functions as a provider of health care services, and

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[12] *Id.*

[13] *See id.* § 1320c-5(a), (c)(1). Regional norms are to be compiled and promulgated by the national governing body for the local PSRO's, the Professional Standards Review Council.

[14] *See, e.g.*, AMA, DELETERIOUS EFFECTS OF PSRO, MEMORANDUM FROM THE AMERICAN MEDICAL ASS'N TO AMA DELEGATES AND ALTERNATES, STATE AND COUNTY MEDICAL ASS'NS, AND NATIONAL MEDICAL SPECIALTY SOCIETIES, March 13, 1974.

> (2) he exercised due care in all professional conduct taken or directed by him and reasonably related to, and resulting from, the actions taken in compliance with or reliance upon such professionally accepted norms of care and treatment.[15]

Considerable ambiguity obfuscates the meaning of this untested provision. First, the scope of the provision is unclear. Second, the effect of the provision in malpractice litigation in state fora is equally obsure. Third, a grave danger exists that the mirror image of the statute may be thought to be implied: that PSRO standards can be used as an offensive weapon by plaintiffs, with departure from PSRO standards serving as a basis for malpractice liability. This danger may cause PSRO personnel to resist the use of PSRO standards of diagnosis and treatment as a measure of immunity from malpractice liability. In fact, the dominant unofficial position of PSRO officials is that the comprehensive standards contemplated by the federal statute are neither presently available nor will they be so in the foreseeable future.[16] These problems will be analyzed in some detail.

There is a dearth of helpful legislative history regarding the civil immunity provision. The PSRO statute was added by the Senate Finance Committee as an amendment to the Social Security Amendments of 1972.[17] Amounting to nearly a thousand pages — of which the PSRO statute was a relatively minor provision — these amendments comprised the longest bill ever considered by Congress.[18]

The only detailed analysis of the PSRO civil immunity provision is contained in the Senate Finance Committee Report which accompanied its introduction. Analysis of this piece of legislative history is vital to an understanding of the scope of the immunity provision.[19] The report states:

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[15] 42 U.S.C. § 1320c-16(c) (Supp. IV, 1974).

[16] This is the view most often expressed by both local and national PSRO officials during personal conversations with the author which took place during 1975-1976.

[17] *See* H.R. CONF. REP. No. 1605, 92d Cong., 2d Sess. 1, 58-59 (1972). *See also* S. REP. No. 1230, *supra* note 9, at 254-69; 118 CONG. REC. 1017 (1972)(remarks of Senator Long).

[18] 118 CONG. REC. 32477 (1972)(remarks of Senator Bennett).

[19] *See, e.g.*, JOINT STAFF OF SENATE COMM. ON FINANCE AND HOUSE COMMITTEE ON WAYS AND MEANS, 92d CONG., 2d SESS., SUMMARY OF SOCIAL SECURITY AMENDMENTS OF 1972, PUBLIC LAW 92-603 (H.R. 1) 17 (Comm. Print 1972); JOINT STAFF OF SENATE COMM. ON FINANCE AND HOUSE COMMITTEE ON WAYS AND MEANS, 92d CONG., 2d SESS., H.R. 1, SUMMARY OF SOCIAL SECURITY AMENDMENTS OF 1972 AS APPROVED BY THE CONFERENCES 17 (Comm. Print 1972); STAFF OF SENATE COMM. ON FINANCE, 92d CONG., 2d SESS., H.R. 1, SOCIAL SECURITY AMENDMENTS OF 1972, OPENING STATEMENT OF SENATE DEBATE 30-31 (Comm. Print 1972); STAFF OF SENATE COMM. ON FINANCE, 92d CONG., 2d SESS., SOCIAL SECURITY AND WELFARE REFORM, SUMMARY OF THE PRINCIPAL PROVISIONS OF H.R. 1, 30 (Comm. Print 1972).

> [P]hysicians and providers would be exempt from civil liability arising from adherence to the recommendations of the review organization (where it was a physician-sponsored and operated PSRO) provided they exercise due care in the performance of their functions. The intention of this provision in the amendment is to remove any inhibition to proper exercise of PSRO functions, or the following by practitioners and providers, of standards and norms recommended by the review organization. Thus, a physician following practices which fall within the scope of those recommended by a PSRO would not be liable, in the absence of negligence in other respects for having done so.
>
> Failure to order or provide care in accordance with the norms employed by the PSRO is not intended to create a legal presumption of liability.
>
> The exemptions from civil liability would apply to a range of patterns which fall within the scope of the norm, to the extent that such a range is considered acceptable by the PSRO in accordance with regulations of the Secretary. For example, the usual length of stay for a given illness might be 6 days, but an individual practitioner might only hospitalize his patient for 4 days. In this case the doctor might be motivated to keep his patient in the hospital for an extra 2 days to assure himself of exemption from liability. However, as described above, the PSRO could approve a range of norms, each of which was considered medically acceptable by the PSRO, which could encompass a hospital stay of 4 days as being sufficient. It is not intended, however, that this protection preclude the liability of any person who is negligent in performing PSRO functions or who misapplies or causes to be misapplied the professional standards promulgated by a review organization.
>
> A physician or provider should not be relieved of responsibility where standards or norms are followed in an inappropriate manner or where an incorrect recommendation by the PSRO is induced through provision of erroneous or incomplete information.[20]

Although imprecise, this description of the immunity provision is helpful in defining the limits of its intended reach. The committee's report contemplates that a physician or other provider who properly complies with the "norms of care and treatment" supplied by the local PSRO will be exempt from liability for claims that he chose an inappropriate course of treatment; the physician, however, will not be immune to claims that he failed to exercise due care in administering the particular therapy or diagnostic procedure.[21] For example, a surgeon should be able to rely on PSRO norms for protection against a claim that he unnecessarily or inappropriately undertook exploratory abdominal surgery; but he could still be held liable for leaving his scalpel behind.

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[20] S. REP. No. 1230, *supra* note 9, at 267.

[21] *See* 42 U.S.C. § 1320c-16(c)(2)(Supp. IV, 1974); S. REP. No. 1230, *supra* note 9, at 267.

However, the full potential effect of this provision cannot be adequately explored without a realistic analysis of the PSRO norms, standards, and criteria.

B. PSRO Norms, Standards, and Criteria

It is by no means clear that the scheme envisioned by the authors of the PSRO statute will ever be fully realized. The statute contemplates that local PSRO's will define a range of professionally acceptable standards for diagnosis and treatment,[22] and that health care providers whose modes of treatment in particular cases fall within this acceptable range will be given the protection of the immunity provision.[23] Discussions with both physicians and PSRO officials, however, have indicated not only that the development of comprehensive and detailed professional standards has been and will continue to be slow and piecemeal, but also that the degree of specificity and detail of the standards will vary tremendously for different diagnostic and therapeutic categories.[24] Thus, the actual effect of the immunity provision will vary according to the type of PSRO norms, standards, and criteria available in each case.

In addition, the process of determining whether the medical services and items at issue were medically necessary and met professional standards of quality may be inevitably more subtle than envisioned by Congress. In pursuance of their mandate for review, PSRO's have developed a two-tiered system for the base-line determination of reimbursability.[25] First, in order to identify questionable claims, a non-physician health care provider screens all cases in which federal reimbursement is sought.[26] Second, detailed review by PSRO physicians is given to the small group of cases[27] in which the course of treatment approaches the outer limits of acceptable medical practice as defined by the PSRO. Initially, the propriety of federal reimbursement is determined by a rotating committee composed primarily of PSRO physicians;[28] however, subsequent administrative and judicial review is available to both providers and patients.[29]

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[22] *See* notes 11 & 12 and accompanying text *supra*.

[23] *Id.*

[24] See note 16 *supra*.

[25] PROGRAM MANUAL, *supra* note 5, at §§ 701, 705.16, 709.

[26] Interview with Dr. John Ball, Office of Professional Standards and Review, United States Dep't of Health, Education, and Welfare, Rockville, Md., August 19, 1975.

[27] *Id.* (initial estimate of 10 per cent of total cases screened). Such comprehensive screening may be curtailed after initial PSRO development in order to permit more careful scrutiny of selected areas of medical practice. *See* PROGRAM MANUAL, *supra* note 5, §§ 705.14(a)(1), .23.

[28] 42 U.S.C. § 1320c-4 (Supp. IV, 1974). *See also* PROGRAM MANUAL, *supra* note 5, at Ch. VII (provisions also made for the assistance of non-physican health care providers).

[29] 42 U.S.C. § 1320c-8 (Supp. IV, 1974).

The principal "norms" of diagnosis and treatment currently being developed by PSRO's are screening criteria for use by non-physician health care personnel in identifying unusual cases.[30] These standards, however, do not constitute a comprehensive handbook of acceptable courses of treatment. Although a comprehensive scheme designed to be measured against local standards of good medical practice seems inherent in the thinking which produced the PSRO statute,[31] the practice of medicine is so complicated that any rapid attempt at facile codification is an exercise in futility. Thus, the screening criteria now being developed by the PSRO's normally attempt only to set forth the gross aspects of normal practice. This approach is mandated by the need to provide some rational and convenient method of isolating aberrant cases for closer scrutiny, only some of which will involve poor medical practice.[32]

Currently, the American Medical Association (AMA), under a contract with HEW and in cooperation with various specialty societies, is in the process of developing model sets of screening criteria for use by PSRO's.[33] These criteria follow a format prescribed by the National PSRO Council and are designed for adaptation to local conditions by local PSRO's.[34]

Although local PSRO's are responsible for developing and applying their own local standards,[35] it is likely that the model screening criteria developed under the AMA-HEW contract will have a very significant impact at the local level as criteria used to select aberrant cases for further review. In addition, these criteria, when modified and expanded, will serve as the format for sets of PSRO norms, standards, and criteria to be circulated to local health care providers.[36] Local PSRO's which independently desire to develop screening criteria for particular diseases are encouraged to follow the approved format[37] and to refrain from expending a "substantial amount of its resources on de novo criteria development."[38] Indeed, the AMA project has produced a draft set of screening criteria containing nearly 800 pages, covering hundreds of diagnostic

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[30] PROGRAM MANUAL, *supra* note 5, at §§ 701, 709.

[31] *See* S. REP. No. 1230, *supra* note 9, at 254-69.

[32] AMERICAN MEDICAL ASS'N DRAFT, MODEL SCREENING CRITERIA TO ASSIST PROFESSIONAL STANDARDS REVIEW ORGANIZATIONS, May, 1975. [hereinafter cited as AMA DRAFT].

[33] *Id.*

[34] *See* PROGRAM MANUAL, *supra* note 5, at §§ 709.11-.15 (Particular emphasis is given to regional variations in normal lengths of hospital stay.).

[35] 42 U.S.C. § 1320c-5 (Supp. IV, 1974).

[36] *See* PROGRAM MANUAL, *supra* note 5, at § 709; *cf.* Comment, *PSRO: Malpractice Liability and the Impact of the Civil Immunity Clause*, 62 GEO. L.J. 1499, 1506 (1974).

[37] Letter from Dep't of Health, Education, and Welfare, Health Services Administration, Bureau of Quality Assurance to PSRO Planning, Conditional, and Support Center Organizations, February 18, 1975, at 2-3 (PSRO Transmittal No. 17).

[38] *Id.* at 3.

and therapeutic categories and designed to encompass 75 percent of hospital admissions in many specialized areas.[39]

Other existing sets of screening criteria are currently being used in some hospitals for identifying questionable cases for review by staff committees.[40] These systems of review will be integrated with the PSRO review mechanism and, upon a favorable PSRO determination regarding their effectiveness, the institutional committees which implement them will be delegated the power to act as review agents for the local PSRO.[41] Committees of staff physicians now involved with the review process in hospitals, thus, will often continue that function as agents for the PSRO. Alternatively, the PSRO may set up its own committees.[42]

The criteria by which these committees decide the questions of medical necessity, quality of care, and appropriateness of facility will, in all probability, never be formalized beyond the present partial codification.[43] This is readily apparent since other than the development of model screening criteria and a demand that local PSRO's review other model sets of criteria as well as available local, regional, and national data,[44] no attempt has been made to prescribe the content or degree of specificity contained in the materials to be used by the PSRO physicians in the review process.

Local PSRO norms, standards, and criteria are to be developed in a process of consultation among local physicians and other health care providers, who will utilize the particular knowledge of specialists in their respective areas of expertise.[45] The extent to which these standards re-

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[39] *See* AMA DRAFT, *supra* note 32.

[40] *See* American Medical Ass'n v. Weinberger, 395 F. Supp. 515 (N.D. Ill. 1975).

[41] 42 U.S.C. § 1220c-4(e) (Supp. IV, 1974). *See* PROGRAM MANUAL, *supra* note 5, at §§ 720 *et seq.*

[42] PROGRAM MANUAL, *supra* note 5, at § 720.

[43] *Id.* at § 709. The PROGRAM MANUAL provides that

> [i]n-depth review should be performed by peers using a combination of more detailed norms, criteria and standards [than used in the initial screening process] and an assessment of a patient's individual clinical and social situation and the resources of the institution in which care is being provided.

Id.

In addition, the PROGRAM MANUAL defines norms, standards, and criteria as follows:

> Norms—Medical care appraisal norms are numerical or statistical measures of usual observed performance.
>
> Standards—Standards are professionally developed expressions of the range of acceptable variation from a norm or criterion.
>
> Criteria—Medical care criteria are predetermined elements against which aspects of the quality of a medical service may be compared. They are developed by professionals relying on professional expertise and on the professional literature.

Id.

[44] *See id.* at § 709.15.

[45] *Id.* at §§ 709.k *et seq.*

flect an acceptable range of medical behavior is the extent to which the divergent beliefs of local practitioners will be accommodated. Moreover, when dissent exists concerning the adequacy of a PSRO standard for a given medical problem, no process of administrative or judicial review is provided for in the *PSRO Program Manual*.[46] More importantly, PSRO standards should not be amenable to judicial review and alteration in the context of malpractice litigation.[47]

Multiple sets of criteria for diagnosis and treatment may be simultaneously applied within a PSRO area.[48] Thus, in any given PSRO area, various hospitals may use different sets of norms, standards, and criteria, and these may vary both in their substantive content and in their degree of specificity. Furthermore, different standards may exist with respect to the same disease for different types of PSRO review.

The primary review processes to be initially undertaken by the PSRO are "admission certification" and "continued stay review." In admission certification, an assessment is made of the medical necessity of a patient's admission to a hospital, and a diagnosis-specific or a

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[46] *See* PROGRAM MANUAL, *supra* note 5. Officials at the national Office of Professional Standards Review have indicated informally that that organization envisions that all such disputes will be settled locally, and the absence of authority leaves open the question concerning the possibility of judicial review in the federal courts under, *e.g.*, 28 U.S.C. § 1361 (1970). Nevertheless, some review should be available to ensure the accommodation of minority points of view in the PSRO standards.

[47] It is doubtful whether review of PSRO standards could be appropriately undertaken in a malpractice suit; however, this question is likely to arise. That is, faced with the defense that the physician-defendant properly relied upon professional standards of diagnosis and treatment applied by the local PSRO, a plaintiff may seek to claim that the PSRO standards were themselves in error and thus did not reflect good medical practice. The proper judicial response would be to reject such a challenge. Whether PSRO standards are out of date or otherwise in error, both practitioners and health care providers should be able to rely upon them until they are changed. In addition, the judiciary is ill-equipped and should be reluctant to attempt to determine what the particular professional standard should be in a given diagnostic or therapeutic category. Conversely a malpractice defendant should not be allowed to seek judicial amendment of PSRO standards, even when he seeks retroactive PSRO approval of his practice in a particular case for the purposes of invoking the defense of compliance therewith.

[48] Section 709.15 of the PROGRAM MANUAL, *supra* note 5, provides:

> Those hospitals performing PSRO review which have developed criteria and standards and selected norms for admission certification and continued stay review prior to their development or selection by the PSRO may utilize these parameters until the PSRO establishes committees for this purpose. Such PSRO committee(s), when formed, can then either accept the hospital's norms, criteria or standards or require changes in them which are consistent with the parameters developed by the PSRO committee(s). In addition, where a PSRO committee has not developed criteria or standards or selected norms for particular diseases, problems or procedures, the hospital may develop or select such parameters and use them if the PSRO approves.

problem-specific length of stay is assigned; thereafter, any extant federal reimbursement will be terminated unless recertification takes place.[49] Continued stay review, which occurs during a patient's hospitalization, is "an assessment of the medical necessity of a patient's need for continued confinement at a hospital level of care and may also include a detailed assessment of the quality of care being provided."[50] In addition to these two types of review, which have been the subject of considerable controversy,[51] PSRO's will undertake Medical Care Evaluation Studies—in-depth, retrospective assessments of particular areas of health care which are potentially ripe for improvement.[52] Sets of norms, standards, and criteria for these studies will vary with the problem area considered and may be developed ad hoc for any particular study.[53] Finally, PSRO's may undertake Retrospective Individual Claims Review—a retrospective investigation of individual hospital claims to "be used only when required forms of review have not been implemented or, where implemented, have not been performed effectively."[54]

Despite these possibilities for variation, the *PSRO Program Manual* clearly anticipates some general codification of norms, standards, and criteria to be distributed to local practitioners:

> When the PSRO has completed and approved its initial set of norms, criteria, and standards for admission certification and continued stay review, it will be responsible for their dissemination to the health care practitioners and hospitals in its area.[55]

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[49] *Id.* at §§ 705.11-.13. Section 705.14(b) provides that preadmission certification of elective admissions may also be required.

[50] *Id.* at § 705.21.

[51] In American Medical Ass'n v. Weinberger, 395 F. Supp. 515 (N.D. Ill. 1975), the court granted a preliminary injunction against the implementation, by the Department of HEW, of certain regulations requiring hospitals to establish utilization review committees as a precondition to Medicare and Medicaid reimbursement. An earlier constitutional challenge to certain provisions of the PSRO statute was dismissed under FED. R. CIV. P. 12(b)(6) for failure to state a claim upon which relief could be granted. Association of Physicians & Surgeons v. Weinberger, 395 F. Supp. 125 (N.D. Ill. 1975). In that case plaintiffs challenged the civil immunity provision, arguing that Congress had exceeded its powers in enacting the provision. The court found that plaintiffs lacked standing and that the suit was premature and accordingly dismissed the complaint. *Id.* at 139.

[52] See PROGRAM MANUAL, *supra* note 5, at §§ 705.3, .31.

> [These studies] may be prompted by cases in which screening parameters have indicated possible instances of substandard quality. Alternatively, they may focus on subjectively perceived instances of medical care administrative inefficiency or substandard quality.

Id. at § 705.34(c).

[53] *Id.* at § 705.35.

[54] *Id.* at § 707(b).

[55] *Id.* at § 709.21.

Though basically consisting of the model screening criteria currently being developed by the AMA, these initially promulgated norms, standards, and criteria will likely be adapted to local conditions.[56] However, the *PSRO Program Manual* also provides that norms, standards, and criteria developed and used in medical-care evaluation studies, retrospective individual claims review, and analysis of performance profiles of individual practitioners or institutions must be distributed to health care practitioners and hospitals in the PSRO area.[57]

The shape which these sets of norms, standards, and criteria will take is, as yet, not entirely clear. The model format for the development of criteria,[58] is designed to incorporate local norms of practice.[59] These screening criteria are designed for measuring the quality of care in both the retrospective studies and the concurrent review process.[60] Thus, despite the potential deluge of sets of norms and criteria, it is likely that the basic format developed for screening criteria will be adapted and amplified to meet these other needs. It remains doubtful, however, that any comprehensive scheme of standards, that is, "professionally developed expressions of the range of acceptable variation from a norm or criterion,"[61] will be forthcoming, except to the extent screening criteria reflect such allowable variation.

What is acceptable practice in one case, because of the idiosyncracies of the patient, may be unacceptable in another. Where treatment is abnormal, case by case determinations of medical necessity and adequate quality will have to be made and only rarely should a given course of treatment be conclusively presumed to be appropriate or inappropriate in all cases involving a particular medical problem. Practice which deviates from the statistical norm may nevertheless be proper in a given case, and the PSRO review process must reflect this fact if it is to deal adequately with the complexities of medical practice. By implication from their function, the PSRO screening criteria are cognizant of this exigency. The criteria, designed to identify aberrations, merely define the general characteristics of expected treatment in ordinary cases involving a particular medical problem. They do not attempt to define the manner in which physicians must practice medicine.[62]

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[56] See notes 33 through 36 and accompanying text *supra*.

[57] PROGRAM MANUAL, *supra* note 5, at §§ 709.22-.24.

[58] This format, sanctioned by the Director of the Bureau of Quality Assurance, was adopted in the model screening criteria sets which were developed under the AMA-HEW contract. See notes 33 through 36 and accompanying text *supra*; PSRO transmittal No. 17, *supra* note 37; AMA DRAFT, *supra* note 32.

[59] See PROGRAM MANUAL, *supra* note 5, at § 709.1.

[60] *See* PSRO Transmittal No. 17, *supra* note 37, at 3.

[61] PROGRAM MANUAL, *supra* note 5, at § 709.

[62] *See* AMA DRAFT, *supra* note 32.

II. A Prospective Analysis of the Immunity Provision

The civil immunity provision, on its face, is not limited to cases in which a federal health aid recipient claims malpractice, nor does the legislative history of the provision suggest such a limitation.[63] The statute provides that any health care practitioner who treats or diagnoses in compliance with, or in reliance upon, the norms applied by the local PSRO shall not be held liable on the basis of those incidents of medical intervention, provided he has exercised due care.[64]

Arguably, the immunity provision is designed to cover any physician who complies with PSRO standards even though the case ultimately does not fall within PSRO review.[65] This question may be

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The absence of specific direction exposes the malpractice immunity provision to some question concerning its ultimate efficacy. The resolution of this problem will depend to a large extent on the state of development of local PSRO norms, standards, and criteria concerning the particular disease process at issue in a particular case. Screening criteria sets, adapted for local norms of length of stay, will be available early in the development of local PSRO's. Also, comprehensive sets of criteria for diagnosis or treatment will be available to the extent that they have been developed or adopted by hospital review committees; however, it is not likely that such sets of criteria will be distributed to area practitioners until investigated, modified, and finally adopted by the local PSRO as an official document to be promulgated and applied throughout the PSRO area. Therefore, the adapted screening criteria will probably be the major evidence of PSRO norms, standards, and criteria in general use. An individual physician practicing in a hospital, however, should be able to invoke the criteria of medical necessity and quality of care used by the PSRO for review in that hospital, even where the document setting forth these criteria has not been circulated to all physicians in the PSRO area.

[63] *See* S. Rep. No. 1230, *supra* note 9; note 15 and accompanying text *supra*.

[64] 42 U.S.C. § 1320c-16(c)(Supp. IV, 1974). The PSRO norms of diagnosis and treatment, of course, are not based merely upon patterns of practice in cases underwritten by the federal government and reviewed by a PSRO, but upon the totality of medical practice with respect to a given problem. A "double standard" of medical practice—one standard for recipients of federal aid and another for other patients—is certainly not contemplated. *See id.* § 1320c-5; Program Manual, *supra* note 5, at §§ 709.1 *et seq.* Indeed, a double standard would be unworkable since, in treating any given patient, a physician often will not know until after the treatment is concluded whether or not he has been treating a "federal" patient.

[65] This reading of the statute follows from its purpose, *i.e.*, to promote compliance with and reliance upon PSRO standards of good medical practice by local physicians.

It may be argued that the treating physician, notwithstanding his intention or knowledge, cannot be said to have complied with or relied upon PSRO standards with respect to a given patient unless that patient qualifies for federal aid. One commentator has gone further; arguing that PSRO standards cannot be applied, and hence the immunity clause cannot be raised, unless the physician, after choosing a course of treatment for the patient, requests approval from the PSRO. Note, *Professional Standards Review and the Limitation of Health Services: An Interpretation of the Effect of Statutory Immunity on Medical Malpractice Liability*, 54 B.U.L. Rev. 931, 937 (1974). These positions make little practical sense and do not comport with the congressional purpose to provide inducement to health care providers to practice in accordance with PSRO standards. If a physician treats a

mooted if Congress expressly extends PSRO review to all medical practice, either in conjunction with a national system of medical malpractice insurance[66] or with a program of national health insurance.[67]

A collateral question concerns the effect of a PSRO determination regarding federal reimbursability in cases where a recipient of federal aid asserts a malpractice claim. Strictly construed, the statute could be read as entirely precluding malpractice claims if PSRO approval of payment is achieved. This conclusion could be based on the theory that PSRO approval of payment requires a finding that the services or items provided were medically necessary and met professionally recognized standards of health care, and that such a finding is conclusive evidence that the health care provider complied with PSRO standards for purpose of civil immunity. Such a reading, however, would clearly be erroneous. The great volume of cases reviewed by the PSRO[68] and the necessarily limited attention which can be given to each case should preclude the application of an absolute bar to such suits. Certainly a plaintiff should be allowed to assert a physician's lack of due care notwithstanding PSRO certification that the costs of treatment were properly reimbursable; otherwise, valid malpractice claims would easily be precluded on the basis of a very cursory review.

The other side of this problem is more complicated: Where the PSRO has denied federal reimbursement because the medical services or items were not necessary or did not meet professional standards, does the patient who sustained injuries from the defective treatment a fortiori have a valid malpractice claim? The statute itself does not answer this question. Nevertheless, if the apparent congressional intent is implemented, denial of federal reimbursement should not be a basis for malpractice liability.

The Senate Finance Committee stated that "[f]ailure to order or provide care in accordance with the norms employed by the PSRO is not intended to create a legal presumption of liability."[69] This statement apparently was made to preclude plaintiffs, including those who are not federal aid recipients, from claiming that mere deviation from PSRO standards constitutes medical malpractice. Thus, the Finance Commit-

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patient in compliance with PSRO standards, the protection of the civil immunity provision should be extended, irrespective of whether that patient subsequently proves to be validly enrolled in a federal aid program. *Cf.* Note, *The PSRO: Its Impact on Medical Litigation*, 1975 UTAH L. REV. 433, 442, wherein it is similarly suggested that a physician must seek PSRO approval of a proposed treatment to establish due care.

[66] *See, e.g.*, S. 482, 94th Cong., 1st Sess. (1975); H.R. 3122, 94th Cong., 1st Sess. (1975).

[67] *See, e.g.*, S. 3, 94th Cong., 1st Sess. (1975).

[68] *See* PROGRAM MANUAL, *supra* note 5, at § 700.

[69] S. REP. NO. 1230, *supra* note 9, at 267.

tee recognized that, in a given case, good medical practice might deviate from the written standards.[70]

Furthermore, PSRO deliberations and data with respect to particular patients and health care providers are subject to strict confidentiality,[71] which is intended to preclude use of this material in civil suits.[72] In fact, the PSRO statute prohibits, with criminal sanctions, the disclosure of data or information acquired by the PSRO in the exercise of its duties except as necessary under regulations promulgated by HEW.[73]

Thus, even though the civil immunity provision seems designed to protect all health care providers who comply with PSRO norms of care and treatment, regardless of whether the case is subject to PSRO reimbursement scrutiny, PSRO determinations of medical necessity and adequacy of professional medical care should have no effect in civil malpractice litigation. Instead, PSRO deliberations with respect to these determinations will not be available to plaintiffs.[74] If PSRO's are

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[70] It could be argued that this general prohibition need not apply to the case in which the PSRO, in denying federal reimbursement, has in fact found either no medical necessity for the treatment, failure to provide treatment according to professional standards of quality, or both. No intent of Congress can be divined, however, to take this significant step of substituting the PSRO judgment of non-reimbursability for a traditional determination of malpractice liability under state law, and none should be lightly implied. *See* S. REP. No. 1230, *supra* note 9.

[71] 42 U.S.C. § 1320(c)-15 (Supp. IV, 1974).

[72] Letter from Dep't of Health, Education, and Welfare, Director of Bureau of Quality Assurance to PSRO Planning, Conditional and Support Center, February 14, 1975 (PSRO Transmittal No. 16).

[73] 42 U.S.C. § 1320c-15 (Supp. IV, 1974).

Specifications for such regulations have been promulgated by the Director of the Bureau of Quality Assurance of HEW for use by local PSRO's. Under this set of "Policy Statements," data identifiable to a particular patient or provider and PSRO deliberations and sanction reports "shall not be subject to subpoena or discovery proceedings in any civil action," PSRO Transmittal No. 16, *supra* note 72, except for purposes of review of administrative hearings under the Social Security Act. *See* 42 U.S.C. § 205(b) (Supp. IV, 1974) (providing for judicial review of PSRO determinations).

[74] Whether testimony given at an administrative hearing to review a PSRO determination or at a subsequent review hearing in federal court will be admissible in state court proceedings is unclear. For purposes of interpreting the PSRO statute, the federal act and HEW regulations promulgated thereunder should be given preemptive effect to bar the introduction of this testimony in state proceedings. Additional support for this position can be found in the antisubpoena policy statement contained in PSRO Transmittal No. 16, *supra* note 37, which provides that PSRO members, employees, or consultants are not subject to subpoena for the purpose of obtaining information concerning privileged data—data identifiable to a particular patient or physician—or PSRO deliberations. It is submitted that this policy statement is virtually certain to be elevated to an HEW regulation. As such, it will operate with the force of federal law and limit the operation of state tribunals to the extent of its prohibition. *See* U.S. CONST. art. VI, § 2; City of Burbank v. Lockheed Air Terminal, Inc., 411 U.S. 624 (1973); Florida Lime & Avocado Growers v. Paul, 373 U.S. 132, 141-52 (1963).

eventually integrated into state law as a mechanism for determining the question of malpractice liability, this latter aspect of the statutory scheme, and particularly the HEW regulatory framework, will have to be changed; but, at present, PSRO investigations of individual cases, unlike the generalized PSRO norms of diagnosis and treatment, are designed to be fully insulated from malpractice litigation.

A. Exemption From Civil Liability in Malpractice Litigation

The PSRO statute does not provide,[75] nor does its legislative history explain,[76] how the statutory exemption from civil liability is to be effectuated in the context of civil litigation. The crucial question is whether the judge or the jury will decide the claim for civil immunity.

Upon any given set of facts, the exemption is designed to operate as a matter of law.[77] Therefore, the defense of compliance with PSRO norms of care and treatment should be available on a motion for summary judgment[78] addressed to claims that the defendant exercised poor professional judgment in ordering, or failing to order, a particular course of treatment. Absent allegations of negligence as to the administration, as opposed to prescription, of a disputed course of treatment, if the defendant could show that the course of treatment fell within PSRO guidelines for similar cases, summary judgment should be granted.

Defensive use of PSRO standards on a motion for summary judgment would cause a significant change in trial practice. Claims of negligence in choosing an inappropriate method of treatment are very often at the heart of malpractice cases. To support these claims, the plaintiff ordinarily calls expert witnesses, who testify that, given a patient with condition X, only treatment Y is appropriate, and that a course of treatment such as that prescribed by the defendant was therefore improper in the instant case. The defendant then calls an expert witness who presents the opposing view, and the question of liability on the claim then goes to the jury. This marshalling of contralateral experts with subsequent jury decision often could be eliminated by application of PSRO standards via summary judgment.

Summary judgment should not, of course, be granted where the plaintiff makes substantial offers of proof that his condition was so

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[75] *See* 42 U.S.C. § 1320c-16(c) (Supp. IV, 1974).

[76] *See* S. REP. No. 1230, *supra* note 9.

[77] *Id.*

[78] *See* FED. R. CIV. P. 56(c) (Summary judgment may be granted on some or all the plaintiff's claims upon a showing that there is "no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law."). The conclusions concerning summary judgment under FED. R. CIV. P. 56 should also be applicable to analogous motions in state courts.

apparently unusual as to demand treatment different from the "normal" case reflected by the PSRO standards.[79] If the plaintiff's case was diagnostically atypical, thus making "normal" treatment malpractice, his claim should not be foreclosed by the PSRO civil immunity statute. To withstand the motion for summary judgment, however, the plaintiff should be required to show that his case fell outside the PSRO norms.[80] Although the burden is on the movant to show that there is no genuine factual dispute,[81] a court will question a non-moving party to determine what he intends to prove at trial and generally how he intends to prove it in order to discover if a genuine factual dispute exists.[82]

Evidence that a plaintiff's condition was not covered by the PSRO standard upon which a malpractice defendant seeks to rely would ordinarily have to come from the plaintiff, medical records, or from an examination conducted by another health care provider. Under these circumstances, sham factual disputes would be difficult to generate.

Thus, felicitious use of the PSRO standards on motions for summary judgment should eliminate claims of improper choice of medical treatment, provided: (1) the disputed treatment falls within PSRO standards designed to cover a normal case; and (2) the plaintiff is unable to show that his condition was so unusual as to call for deviation from those standards. Where the plaintiff is able to show an unusual condition, the issue of malpractice liability should go to the trier of fact. The PSRO defense will still be efficacious if the finder of fact concludes that

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[79] *See* text accompanying notes 43 through 46 *supra*.

[80] *See* 6 J. MOORE, FEDERAL PRACTICE ¶ 56.15 (2d ed. 1974)[hereinafter cited as MOORE].

[81] 6 MOORE, *supra* note 80, ¶ 56.15, at 2284 & ¶ 56.15, at 2331.

[82] *Id.* The allegations of the complaint are not controlling on a motion for summary judgment; rather, the court is under a duty to pierce the pleadings and ask whether the factual claim is "substantial or . . . only sham and colorable . . . ." *Id.* ¶ 56.15, at 2331. Thus, a claim by the plaintiff that his condition was not covered by PSRO norms would not be sufficient to withstand a motion for summary judgment. He would be required to show, by means of depositions, answers to interrogatories, admissions on file, affidavits, or oral testimony, that he could offer substantial proof at trial that his case was so clearly atypical that PSRO norms would not apply. In the words of Judge (later Justice) Cardozo:

> The very object of a motion for summary judgment is to separate what is formal or pretended in denial or averment from what is genuine and substantial, so that only the latter may subject a suitor to the burden of trial.

Richard v. Credit Suisse, 242 N.Y. 346, 152 N.E. 110, 111 (1926).

> [T]he summary judgment procedure permits a party to pierce the allegations of fact in the pleadings and to obtain relief by summary judgment where facts set forth in detail in affidavits, depositions, admissions on file, and other competent extraneous materials show that there are no genuine issues of fact to be tried.

6 MOORE, *supra* note 80, ¶ 56.15[1.-02], at 2291.

the PSRO standards followed were applicable to the plaintiff's condition. In addition, intervention by the court on behalf of the defendant, based on the PSRO defense, will remain available during trial on a motion for involuntary nonsuit, directed verdict, or a judgment notwithstanding the verdict if the plaintiff's proof at trial is insubstantial.

Under the immunity provision, freedom from civil liability is afforded the defendant only if

> he exercised due care in all professional conduct taken or directed by him and reasonably related to, and resulting from, the actions taken in compliance with or reliance upon such professionally accepted norms of care and treatment.[83]

Thus, the provision rests immunity from liability on a finding of due care in professional conduct. Nevertheless, there is an arguable reading of this ambiguously worded clause which would render the entire immunity provision meaningless: After a trial on the merits establishes due care on the part of the defendant in prescribing a given course of treatment, civil immunity will be granted as a matter of federal law on the basis of compliance with PSRO norms. The framers of the statute clearly intended something different. The statute was designed to preserve claims that the defendant was negligent in carrying out an approprite course of treatment; the surgeon who leaves his scalpel behind must be liable.[84] Conversely, the statute was also designed to bar claims that the defendant followed the wrong course of treatment where he has appropriately complied with PSRO standards of diagnosis and treatment.[85]

In cases where the plaintiff claims only that the defendant failed to follow the proper course of treatment, lack of due care with respect to the actual performance of the specific diagnostic and therapeutic measures will be of no concern. In such cases the "due care" requirement of the immunity provision should be deemed satisfied.[86]

In the context of more complicated cases, where the plaintiff alleges both an improper course of treatment and negligence in the performance of a particular treatment, the meaning of the immunity provision is unclear. It seems most reasonable, however, if the provision is to retain some immunizing effect, that the judge should hear the defense of compliance with PSRO norms prior to trial on the merits and decide its

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[83] 42 U.S.C. § 1320c-16(c)(2)(Supp. IV, 1974).

[84] *See* S. REP. No. 1230, *supra* note 9, at 267.

[85] *Id.*

[86] In such a case the plaintiff's claim could still be disposed of on a motion for summary judgment after a judicial finding that the practices alleged by the plaintiff were within acceptable ranges established under local PSRO norms of diagnosis and treatment. The civil immunity provision should mean at least this much.

validity while assuming that there is no substantial factual dispute concerning the applicability of the PSRO norm. The intended effect of the "due care" provision—denying immunity to the negligent practitioner—will be fully preserved if the case is allowed to go to trial on the question of lack of due care in either carrying out a specific procedure or in applying PSRO norms to the patient's particular case; the jury may still impose civil liability on a negligent practitioner. Moreover, under this approach, the prophylactic effect of the provision in precluding claims that the defendant followed an improper course of treatment when he has, in fact, properly complied with local PSRO norms of diagnosis and treatment will be fully preserved.

Although the meaning of the immunity provision should ultimately be determined in the federal courts, it does not provide a plaintiff with a federal cause of action when used as a defense[87] to a malpractice claim. Therefore, the provision will be used only in state malpractice litigation, except in diversity cases with the requisite jurisdictional amount. Furthermore, even though the federal judiciary wields the power to effectuate significant alterations in state trial procedures,[88] it is consistent with the intent of Congress to preserve the traditional roles of judge and jury under this provision. Thus, questions concerning due care should be preserved for the jury, to the extent provided by state law, and the judge should decide, ordinarily on a pretrial motion for summary judgment or its equivalent, whether the plaintiff alleged and offered substantial proof of any facts suggesting that the practice of the defendant fell outside the range of practices approved by the local PSRO for similar cases. Where the judge finds that a defendant's choice of treatment was not within that approved by the PSRO, or where he finds that the plaintiff has made a substantial offer to prove that his condition was atypical with respect to PSRO standards, he should deny the defendant's motion for summary judgment and allow the case to go to the jury. The plaintiff should then be free to put on expert testimony that the course of treatment followed was inappropriate.

Moreover, the statute should be interpreted to completely bar the use of PSRO standards when due care in the performance of the treat-

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[87] *See* Skelley Oil Co. v. Phillips Petroleum Co., 339 U.S. 667 (1950); Taylor v. Anderson, 243 U.S. 74, 75-76 (1914); Louisville & N.R.R. v. Mottley, 211 U.S. 149 (1908).

[88] *See, e.g.*, Dice v. Akron, C. & Y.R.R., 342 U.S. 359 (1952), where the Supreme Court held that the right to a trial by jury is so substantial a part of the cause of action created by the Federal Employers' Liability Act that the Ohio courts could not apply, in an action under that statute, the Ohio rule that the question of fraudulent release was for determination by a judge rather than by a jury. *See also* Brown v. Western Ry., 338 U.S. 294 (1949).

ment is at issue. For example, a patient suffering from and treated for hiatus hernia—a condition in which the stomach herniates into the hiatus in the diaphragm ordinarily occupied solely by the esophagus—might claim that he sustained injury to his gastrointestinal system from antacid therapy inappropriately undertaken and inappropriately carried out. The defendant should be allowed to rely upon PSRO treatment norms for hiatus hernia as a defense to the claim that antacid therapy was an inappropriate choice of treatment since typical PSRO screening criteria of diagnosis and treatment project antacid therapy in 100 per cent of cases of hiatus hernia.[89] This defense could be raised on a motion for summary judgment and should preclude the introduction of evidence on the plaintiff's claim at trial unless there exists either: (1) a bona fide factual dispute as to whether the plaintiff was suffering from hiatus hernia; or (2) an offer to show that this particular case of hiatus hernia was identifiably different from all others. However, the claim that the defendant improperly administered the therapy, for example, by giving the patient ten times the proper dose, would remain as a question of due care to be decided by the jury at trial. Thus, freedom from civil liability would depend upon whether there was a finding of due care in professional conduct; but if the defendant shows compliance with PSRO norms, consideration of the charge that the course of treatment chosen was improper should be precluded.

Alternate constructions of the civil immunity provision will distort the aim of Congress. At one extreme, to read the provision as leaving both claims to the jury, including the introduction of evidence to show that the particular mode of treatment (antacid therapy in the foregoing example) was inappropriate, would render nugatory the protection which the statute seeks to confer on health care providers who comply with PSRO norms. At the other extreme, to shift the entire question of due care in therapeutic procedures to the judge, as a prerequisite to determining whether compliance with PSRO norms has foreclosed argument concerning the appropriateness of the treatment chosen, would completely disrupt the fact-finding process in state trials. There is no evidence that Congress intended to go so far.[90]

The foregoing discussion has been limited to the implementation of the civil immunity provision in the context of malpractice trials. The application of the provision to cases determined by administrative bodies is less difficult, since a single fact finder will determine both the propriety of the course of treatment and whether due care has been exercised in the application of diagnostic and therapeutic procedures. The defense of compliance with PSRO norms provided by the immunity

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[89] *Cf.* AMA DRAFT, *supra* note 37, at 333-34.

[90] *See* S. REP. NO. 1230, *supra* note 9.

provision will continue to be available in state administrative tribunals since the federal statute will remain preemptive of state law regardless of any procedural or substantive variations which are wrought at the state level.[91] Also, the federal defense should remain available to preclude both the admission of evidence and argument regarding choice of treatment if there is no real dispute as to whether the course of treatment fell within PSRO ranges of acceptability.

Similarly, the protection afforded by compliance with PSRO norms should have a significant role in cases handled by arbitration, although the relative informality of these proceedings may render the protection less effective. Since textbook evidence is often more freely admissible in an arbitration proceeding,[92] it is likely that PSRO norms will be merely another piece of textbook evidence at arbitration proceedings. The effect of the norms and the civil immunity provision, thus, will largely depend on the understanding of the arbitrator and the skill of counsel. Nevertheless, the effect of the civil immunity provision will be significantly diminished in cases of binding arbitration since close judicial scrutiny of the effect given the PSRO norms will not be available. For this reason, however, the problem is also likely to remain invisible in many arbitration cases.

B. PSRO Norms as a Basis for Liability

The prospect which most frightens physicians is that PSRO standards of diagnosis and treatment may be used as the basis for claims of malpractice. These standards are available to all health care providers in the PSRO area and are not confidential.[93] As previously indicated, the immunity provision makes it virtually certain that PSRO norms will play a substantial role in the determination of liability in many malpractice cases. Moreover, the cooperation of PSRO officials in explaining the meaning and limitations of PSRO norms of diagnosis and treatment, especially in early cases, may help prevent inappropriate use of PSRO norms. In this context, it is crucial that the intent of Congress be implemented so as to preclude use of PSRO norms as a sword by the malpractice plaintiff. According to the framers of the statute, "[f]ailure to order or provide care in accordance with the norms em-

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[91] *See* note 74 *supra*.

[92] *See* Note, *Medical Treatises as Evidence—Helpful But Too Strictly Limited*, 29 U. OF CINN. L. REV. 255 (1960).

[93] PROGRAM MANUAL, *supra* note 5, at § 709.21. Both local and national PSRO officials share this fear and as a result, in conversation with the author, have indicated that this has been a significant factor in persuading them that PSRO's should exist entirely isolated from malpractice litigation.

ployed by the PSRO is not intended to create a legal presumption of liability."[94]

Although this language clearly indicates that deviation from PSRO standards should not raise a "presumption" of liability, the use of the term "presumption" may give rise to debate. At a minimum, the report must mean that mere deviation from the PSRO standards should shift neither the burden of going forward with the evidence nor the ultimate burden of proof. Yet the question remains whether the PSRO standards will be admissible to support an inference of malpractice. The senate report, read strictly, could possibly countenance such a use of the standards: Consonant with local evidentiary requirements concerning the introduction of documentary evidence,[95] PSRO standards could be introduced by a plaintiff as evidence of standard medical practice. Such an interpretation would be a serious error. To allow offensive use of PSRO standards would indeed impose "cookbook medicine" on health care providers where any departure from the PSRO guidebook would be a basis for an inference of malpractice. Congress never intended this result.[96]

The word "presumption" in the senate report is used broadly and should be interpreted to mean "inference" as well as strict "presumption."[97] The senate report indicates that the statute does not contemplate the use of PSRO standards as an offensive weapon.[98] Moreover, written PSRO standards are unsuitable for such a use. The PSRO standards do not define good medical practice but merely describe ordinarily acceptable medical practice; and deviation from ordinary practice is not necessarily bad practice.[99] Thus, deviation from PSRO standards should mean only that the defendant cannot invoke the protection

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[94] S. REP. No. 1230, *supra* note 9, at 267.

[95] See note 89 *supra*.

[96] *See* S. REP. No. 1230, *supra* note 9, at 267.

[97] *Id.*

[98] *Id.*

[99] If a plaintiff were allowed to introduce PSRO standards as an inferential basis for liability, the defendant would be placed in the position of showing either that the PSRO norm did not apply to the plaintiff's case, or that his choice of treatment other than the PSRO standard was medically justifiable. In either case, the burden of going forward would be effectively, if not formally, shifted to the defendant. This would grant the PSRO standards the force of a presumption, *sub rosa*. Congress never intended such an effect. The statute should be interpreted to completely prohibit the use of PSRO standards by plaintiffs. For an optimistic view of the effect of the PSRO program on medical malpractice litigation see Simmons & Ball, *PSRO and the Dissolution of the Malpractice Suit*, 6 TOLEDO L. REV. 739, 762 (1975). There, the authors maintain that PSRO standards can be raised by a defendant under the civil immunity provision; however, their position regarding offensive use of the standards is ambiguous. *But cf.* Note, *The PSRO: Its Impact on Medical Litigation*, 1975 UTAH L. REV. 433, 441 (The authors conclude that the PSRO norms will "substantially ease" the plaintiff's evidentiary burden.).

of the civil immunity provision. The defendant should be free to defend his course of treatment; the PSRO standards should have no offensive role in malpractice litigation.

Altering the previously noted example,[100] a patient who had been treated for hiatus hernia without antacid therapy could attempt to show, by citing PSRO norms, that antacid therapy is called for in every such case.[101] However, the defendant physician may have omitted this course of treatment for sound medical reason.[102] Good medical practice would then lie outside the "normal" case contemplated by the PSRO standards. Except when used as a part of the physician's special defense under federal law—in which the PSRO standards must be used, state evidentiary limitations notwithstanding[103]—PSRO standards should be no more admissible than any other piece of textbook evidence.[104] Thus, even in states where treatise evidence is freely admissible on the question of liability,[105] mere deviation from the PSRO standards should be barred as an inferential or presumptive basis for liability.[106]

The statute's failure to deal explicitly with this problem is a weakness. Despite the relative clarity of the legislative history, confusion on this point has caused both health care providers and PSRO officials to be reluctant to countenance any uses of PSRO norms in malpractice litigation. The PSRO statute should be amended to make it clear that PSRO norms, standards, and criteria are not to be used as an inferential basis for malpractice liability.

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[100] See text accompanying note 89 *supra*.

[101] *Id.*

[102] For example, the patient might have been achlorhydric, with a substantial or total absence of acidic gastric secretions, so that antacid therapy would have been inappropriate.

[103] *See* note 88 *supra*.

[104] As a matter of federal law, PSRO standards, when used in defense, will certainly override an apparently different standard of care as determined by state law. However, except in the limited case of a defense under 42 U.S.C. § 1320c-16(c) (Supp. IV, 1974), the state rule will apply unchanged. *See, e.g.*, Eckleberry v. Kaiser Foundation N. Hosp., 226 Ore. 616, 359 P.2d 1090 (1961); Grantham v. Goetz, 401 Pa. 349, 164 A.2d 225 (1960); *cf.* Watterson v. Conwell, 258 Ala. 180, 61 So. 2d 690 (1950); MASS. GEN. LAWS ch. 233, § 79C (1965); NEV. REV. STATS. § 51.255 (1971). *See generally* Note, *Malpractice and Medical Testimony*, 77 HARV. L. REV. 333, 341-42 (1963); Note, *supra* note 92.

[105] See note 104 and accompanying text *supra*.

[106] For example, a child with severe proteinuria, manifesting the nephrotic syndrome, might be subjected to an inulin clearance test in a major diagnostic center to ensure an accurate measurement of glomerular filtration rate. The ordinary clearance test of indogenous creatinine might be omitted in this situation if severe muscle wasting had occurred. Yet the PSRO standard may project the text-accurate creatinine clearance test in every case. To allow deviation from PSRO standards in such a case to constitute evidence of improper practice would be appalling. *See* AMA DRAFT, *supra* note 32, at 546-47.

III. Conclusion

The available PSRO norms, standards, and criteria afford only partial protection to health care providers. Claims of deviation from the proper course of treatment may be disposed of without trial upon a showing of compliance with the acceptable pattern of treatment represented by the PSRO norms if the plaintiff can make no substantial offer to prove that his case required non-standard medical treatment.[107] Moreover, detailed aspects of treatment in most of the diagnostic and therapeutic categories covered by the PSRO screening criteria, although theoretically susceptible of codification, are as yet untreated by comprehensive standards.[108] Significantly, litigation on these questions cannot be foreclosed under the civil immunity provision until ranges of normal and acceptable medical behavior with respect to these more detailed aspects of diagnosis and treatment are either developed for PSRO's or are adopted by PSRO review committees for particular hospitals.

Factual questions concerning due care in the performance of otherwise appropriate diagnostic or therapeutic procedures will remain for resolution by the trier of fact.[109] To the extent, however, that PSRO's undertake to define ordinarily acceptable methods of carrying out specific procedures, such as schedules of acceptable equipment and sequence of preparation and procedure in cardiac catherterization, claims that an improper choice of technique was made may be foreclosed under the immunity provision. However, claims regarding negligent administration of an otherwise proper course of treatment will not be foreclosed by the statute. Also, an element of uncertainty exists since acceptable ranges of behavior regarding the informed consent required of a patient prior to medical intervention are as yet untouched by PSRO standards.[110]

Both national and local PSRO officials fear that misuse of PSRO norms in the medical malpractice arena will hinder the review process and damage the PSRO program. There has even been some indication that the national office of Professional Standards Review will seek to intervene in any suit in which the immunity provision is raised[111] and attempt to acheive an absolute bar to the introduction of PSRO standards into evidence. There is an alternate position that PSRO standards

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[107] *See* notes 81 through 83 and accompanying text *supra*.

[108] *See* notes 33 through 43 and accompanying text *supra*.

[109] *See* notes 77 through 89 and accompanying text *supra*.

[110] *See* AMA Draft, *supra* note 32.

[111] Such a position was taken by a high ranking member of the Office of Professional Standards and Review of the United States Dep't of Health, Education, and Welfare, Rockville, Maryland, who, in deference to his request shall remain anomymous.

can never be used under the civil immunity provision and that the statute should be entirely ignored. It seems unlikely that this position can be sustained. It will be difficult for the national PSRO office to maintain that health care providers cannot rely on PSRO standards which have been developed explicitly to aid in measuring quality of care when the federal statute clearly demands that protections of some sort be afforded those who comply with or rely upon PSRO standards.[112]

A middle road should be taken. PSRO norms should be given no more weight than they deserve, thus limiting scrutiny of medical practices. At the same time, they should, to the extent that is rationally possible, fulfill their part in the statutory scheme, which is to provide a screening mechanism against frivolous cases and to eliminate some claims, based on an alleged improper course of treatment, in areas where experts disagree. PSRO standards cannot, of course, settle bona fide factual disputes, but they can prevent the plaintiff's use of expert testimony to denigrate the defendant's choice of treatment.

Once the courts delineate the meaning of the civil immunity provision, written PSRO norms should have a largely unseen effect on medical malpractice litigation. By clarifying what constitutes acceptable treatment for many conditions, the standards are likely to discourage unjustified claims and promote the settlement of valid claims. Further elaboration of PSRO standards will extend this process. Used wisely, the civil immunity provision will induce stability and fairness. Interpreted incorrectly, the provision will promote "cookbook medicine" and, thus, exacerbate the problems in an area already in turmoil.

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[112] *Cf., e.g.*, Note, *PSRO: A Status Report on Medical Peer Review Under the 1972 Social Security Act Amendments*, 6 LOYOLA U.L.J. 90, 98 (1975).

MISSISSIPPI REGULATORY POLICY IN THE ELECTRIC UTILITY INDUSTRY

*Rubel L. Phillips**

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Utility regulation in Mississippi has had a long and frequently turbulent history. In 1805, prior to statehood, the territorial legislature declared all roads and ferries to be public domain and county courts

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were authorized to establish ferries and toll bridges and require a bond for their operation and the establishment of tolls for their use.[1] Over the years this jurisdiction was transferred to the board of county police and subsequently to the county board of supervisors.[2] By the late 1830's, the state legislature, as a common practice, chartered turnpike companies with authority to build turnpike roads and establish and charge tolls for their use.[3] During the early and middle part of the nineteenth century, practically all railway charters were granted by state legislatures, and Mississippi was no exception. These charters generally empowered the railroads to establish and collect tolls within maximum limits established by the legislative grant.

By 1884, rail rates were high and service was not particularly good; consequently, the public was highly suspicious of railroads. Even though rail carriers had apparently reduced rates in Mississippi, Governor Lowery, in his message to the legislature on January 9, discussed the need for supervision of railroads. Upon the recommendation of the Governor,[4] the Mississippi Legislature created the Mississippi Railroad Commission,[5] which was the predecessor of the Mississippi Public Service Commission.[6]

During the 1955 election campaign, Judge J.P. Coleman, a candidate for governor, placed great emphasis on the need for effective statewide regulation of gas and electric companies, as well as other utilities already under the jurisdiction of the commission. The public service commission was, at the time, subject to an injunction issued by the Chancery Court of Hinds County which had enjoined enforcement of a rate order adopted by the commission in connection with telephone rates.[7] There was general dissatisfaction among the public with what was considered to be ineffective[8] regulation of telephone rates by the commission and the lack of any statewide regulation of gas and electric utilities.[9] Upon the recommendation of Governor Coleman,[10] the legisla-

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[1] Act of March 1, 1805, ch. I, § 1, [1816] Gen. Laws Miss. 292.

[2] Miss. Rev. Code § XI art. 41, 42 (1857).

[3] *E.g.*, Act of May 13, 1837, [1837] Gen. Laws Miss. 300; Act of Feb. 12, 1820, ch. XXXVIII, [1820] Gen. Laws Miss. 54.

[4] Miss. S. Jour. 37-8 (1884).

[5] Act of Mar. 11, 1884, ch. XXIII, § 4, [1884] Gen. Laws Miss. 31.

[6] Act of April 8, 1938, ch. 140, § 13, [1938] Gen. Laws Miss. 185.

[7] Southern Bell Tel. & Tel. Co. v. Mississippi Pub. Serv. Comm'n, No. 42, 573 (Ch. Ct. Hinds County, Miss., Oct. 22, 1951); Southern Bell Tel. & Tel. Co. v. Mississippi Pub. Serv. Comm'n, No. 37,007 (Ch. Ct. Hinds County, Miss., July 2, 1948).

[8] Much of the commission's statutory jurisdiction was general and not specific, dating back in many instances to the 1892 Code, and there were few, if any, statutory provisions relating to commission procedure.

[9] Gas and electric companies generally operated under municipal franchises approved

ture enacted the Public Utilities Act of 1956[11] which, although amended in minor respects, remains the basic utility law in our state.[12]

While rate regulation has been a major function of the commission, rate matters have, surprisingly enough, not consumed the major part of the commission's time and regulatory efforts. The most far-reaching decisions of both the commission and the courts have involved competition between utilities and particularly competition within the electric utility industry.

Every citizen of our state is, perhaps today more than ever before, vitally affected by utility regulation. The recent fuel crisis has brought to the fore the significance of regulation of electric utilities. For this reason this article addresses the Mississippi regulatory policy in relation to the electric utility industry in our state. An effort has been made to include within this discussion the more significant considerations of utility regulation in general with the hope that this discussion will be of some benefit to members of the Mississippi Bar, as well as to others who are concerned about the future of utility regulation in this state.

I. Origins of Public Utility Regulation

For as long as there has been organized society some businesses and professions have been recognized as more immediately and directly affecting the public welfare than others.[13] Businesses of this nature have, therefore, been subjected to more specialized regulation than general

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and issued by the various municipalities within their respective service areas. Not until 1956 was the Mississippi Public Service Commission granted specific jurisdiction to regulate gas and electric companies.

[10] *See* Miss. S. Jour. 506 (1956).

[11] Act of Mar. 29, 1956, ch. 372, [1956] Gen. Laws Miss. 531.

[12] Miss. Code Ann. §§ 77-3-1 *et seq.* (1972).

[13] Regulation of private industry has been attempted by government from the earliest times. All attempts at such regulation owed much to a very ancient ideal of social justice, which as applied to economic life by the early Church Fathers, became their very famous doctrine of *justum pretium*, i.e., "just price." They opposed this idea to the contemporaneous doctrine of *verum pretium*, i.e., "natural price," which Roman law had derived from Stoic philosophy. As contrasted with the doctrine of natural price, which justified any price reached by agreement in effecting exchanges between willing buyers and willing sellers, the "just price" doctrine drew attention to the coercion which may reside in economic circumstances, such as food famine where a buyer is made willing by his economic necessities. Hence, in order to draw the sting of coercion, the early Church Fathers, following St. Augustine, considered only that trading to be legitimate in which the trader paid a "just price" to the producer, and in selling, added only so much to the price as was customarily sufficient for his economic support. There was to be no unjust enrichment.

M. Glaeser, Public Utilities in American Capitalism 196 (1957); *see* P. Garfield & W. Lovejoy, Public Utility Economics 2-4 (1964).

business enterprises.[14]

Exactly when government first began to regulate these callings, which have come to be known as utilities, is uncertain, but it is known that some 2,000 years before the birth of Christ, Hammurabi's Code provided for the regulation of fees, wages, rents, and prices.[15] The Code fixed physicians' fees and regulated wine merchants, builders, and boatmen, making the latter, as carriers, liable for goods lost in transit.[16] Under Roman law, rivers, harbors, and public roads were owned by the state and their use was deemed a public use.[17]

From the earliest times, therefore, there developed a particular body of rules governing pursuits which were considered public in character and thus distinct from general commercial enterprises.[18] The miller was considered to be engaged in a public calling while the cobbler was not, since man's food was more critical than his shoes. The English common law accepted these practical aspects of economics as early as 1266. In that year, Henry III established a regulation relating the price of bread and ale to the price of wheat and barley and prohibiting cornering of the market.[19] In 1349, all English laborers were obliged to serve for the customary wages, and " 'butchers, fishmongers, regrators, hostelors, . . . brewers, bakers, poulterers, and all other sellers of all manner of victuals,' " were bound to sell for a reasonable price.[20] While the ordinary merchant or shopkeeper might sell according to his notion, the innkeeper and the restauranteur could not. In a decision reported in 1460, one English judge is recorded as saying:

> If I come to an innkeeper to lodge with him, and he will not lodge me, I shall have on my case an action of trespass against him; and in the same way if I come to a victualler to buy victual, and he will not sell, I shall have an action of trespass on my case against him; and still in such cases if he will bring a writ of debt against me on such duty I shall have my law.[21]

It is, therefore, apparent that while today we are inclined to justify the regulation of utilities on the ground that a typical utility enjoys, to some degree, a monopoly, this was not so in earlier days. In fact, until the 17th century there appeared to have been little connection between

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[14] H. TRACHSEL, PUBLIC UTILITY REGULATION 5 (1947).

[15] C. EDWARDS, THE HAMMURABI CODE 66 (1904).

[16] *Id.*

[17] W. BURDICK, PRINCIPLES OF ROMAN LAW AND THEIR RELATION TO MODERN LAW 293 (1938).

[18] J. BEALE & B. WYMAN, THE LAW OF RAILROAD RATE REGULATION § 2, at 5. (1907).

[19] *Id.* § 4, at 7.

[20] *Id., quoting* 23 Ed. 3, cap.1.

[21] *Id.* § 9, at 11, *quoting* Y.B. 39 H. VI, 18 pl. 24.

the two.[22] The law of utility regulation seems to have been developing in England prior to the excesses in the grants of Crown patents[23] in the 15th and 16th centuries;[24] a practice particularly distasteful to our founding fathers[25] which involved the monarch's granting unwarranted monopolies and franchises to favored friends and associates.

Experience in this country early[26] demonstrated that the granting of certain monopolies was undoubtedly in the public interest and that regulation should, in some instances, be substituted for competition.[27] The industrial revolution stimulated enterprises unknown to the early common law. These changes consequently altered the relative public interest in existing and emerging businesses. As the common carrier became more important, the miller, barber, surgeon, smith, ferryman, and victualler, while still subject to some regulation, assumed a role less significant than in years past, and public attention was shifted from them to the providers of transportation, communications, energy, and water.[28]

The Supreme Court's decision in *Munn v. Illinois*,[29] which introduced the "public calling" doctrine into American law,[30] may be said to mark the beginning of effective state regulation of utilities in the United States.[31] This case clearly established that the due process clause of the fourteenth amendment did not prevent the states from regulating commercial enterprises of public importance despite their involvement in interstate commerce.[32]

In 1871, the Illinois Legislature, under the mandate of the state's new constitution, established maximum grain storage rates for public elevators.[33] Munn and his associates refused to comply with this statute, were fined, and the case reached the United States Supreme Court.[34] Relying chiefly upon the 17th century writings of Lord Chief Justice Hale,[35] Mr. Justice Waite, speaking for the Court, stated that, except

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[22] *Id.* § 14, at 17-18.

[23] *See* Darcey v. Allin, 11 Co. Rep. 84 (1603).

[24] *See* J. BEALE & B. WYMAN, *supra* note 18, § 14, at 17.

[25] *Id.* § 14, at 17-18.

[26] *See generally* O. POND, PUBLIC UTILITIES § 907 (4th ed. 1913).

[27] F. WELCH, CASES AND TEXT ON PUBLIC UTILITY REGULATION 105 (rev. ed. 1968). This principle is discussed in part IV *A infra*.

[28] *Id.* at 2.

[29] 94 U.S. 113 (1877).

[30] *See* Lovejoy, *Regulation of Business: The Need for a Public Utility Concept*, 3 S. TEX. L.J. 292, 294 (1958).

[31] *Id.*

[32] 94 U.S. at 135-36.

[33] *Id.* at 114-16.

[34] Munn v. People, 69 Ill. 80 (1873), *aff'd sub nom.*, 94 U.S. 113 (1877).

[35] In a 1926 New York Supreme Court decision, Judge Savage characterized the significance of Lord Hales' work as follows:

for the powers delegated to the United States or reserved to the people, the states possessed all the legislative powers of the Parliament of England.[36] After reviewing English decisions, Justice Waite concluded that if the common carrier, miller, ferryman, innkeeper, baker, cartman, or the hackney-coachman exercised "a sort of public office,"[37] it was difficult to see why the plaintiffs in error did not also. Justice Waite continued:

> This brings us to inquire as to the principles upon which this power of regulation rests, in order that we may determine what is within and what without its operative effect. Looking, then, to the common law, from whence came the right which the Constitution protects, we find that when private property is "affected with a public interest, it ceases to be juris privati only." This . . . has been accepted without objection as an essential element in the law of property . . . . Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created. He may withdraw his grant by discontinuing the use; but, so long as he maintains the use, he must submit to the control.[38]

Justice Waite made it clear that the Court would not inquire whether the regulation of grain elevators in Illinois was, in fact, justified.[39] The power to regulate, not the need to regulate, was the question. If such a state of facts could exist, then the Court would assume that it did exist.[40] Reaffirming the common law rule that the reasonableness of a rate is a legislative and not a judicial question, the Court rejected the proposition that the reasonableness of compensation was a judicial question.[41]

> The Treatise of Sir Matthew Hale, *De Jure Maris,* has been so often recognized in this country, and in England, that it has become the textbook from which, when properly understood, there seems to be no appeal by either sovereign or subject, upon any question relating to their respective rights, either in the sea, arms of the sea, or private streams of water . . . . In England, even on rights of prerogative, the courts scan his words with as much care as if they had been found in the Magna Charta; and the meaning once ascertained, they do not trouble themselves to search any further.

Ex parte Jennings, 6 Cow. 518, 536 n.(a)(N.Y. 1826).

[36] 94 U.S. at 124.

[37] *Id.* at 131-32.

[38] *Id.* at 125-26.

[39] *Id.* at 132.

[40] *Id.*

[41] *Id.* at 133-34.

The Court did note that the Chicago grain elevators enjoyed a "virtual" monopoly,[42] but the decision seems to have been grounded less on that observation than on the English common law principle recognizing the power of the sovereign to regulate all forms of business enterprise.[43] Soon thereafter, however, the Court referred to *Munn* as holding that the state might regulate business enterprises which enjoyed a "practical" monopoly to which the public had no choice but resort.[44] The continuing impact of *Munn v. Illinois* is demonstrated by the increase in state regulation of utilities since the turn of the century.

II. The Certificate of Public Convenience and Necessity and State Regulatory Policy

The general regulatory policy of a state may be ascertained by reviewing its statutory provisions concerning the issuance of certificates of public convenience and necessity and court decisions interpreting those statutes.[45] Because these provisions vary in content from state to state, no nationwide pattern of regulatory policy emerges from the statutes alone.[46] All such statutes, however, do have one common thread which lies at the very heart of public utility regulatory theory: A public utility submits to regulation by the state and the state in turn grants the utility—to a greater or lesser extent—a monopoly in a particular service area.[47] The certificate limits or prevents competition within the certified area, and judicial resolution of territorial conflicts between competing utility companies is largely based on the wording of these statutes.[48] Moreover, certification creates the monopolistic character of

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[42] *Id.* at 131.

[43] *See id.* at 126-30.

[44] Budd v. New York, 143 U.S. 517, 545 (1892). *But see* Brass v. North Dakota *ex rel.* Stoeser, 153 U.S. 391, 403 (1894)(rejecting monopoly as a test of whether a business had ceased to be private and thus subject to regulation).

[45] *See* Smyser, *Regulation of Motor Carriers in South Dakota: "Regulated Monopoly" or "Regulated Competition,"* 11 S.D.L. Rev. 27, 30-31 (1966).

[46] Meeks, *Concentration in the Electric Power Industry: The Impact of Antitrust Policy*, 72 Colum. L. Rev. 64, 97 (1972); *see, e.g.*, Ark. Stat. Ann. § 73-240 (Supp. 1975); Cal. Pub. Util. Code §§ 1001-02 (West Supp. 1975); Colo. Rev. Stat. Ann. §§ 11-5-1, -2 (1963); Conn. Gen. Stat. Rev. § 16-249 (1958); Idaho Code § 61-526 (Supp. 1974); Ill. Ann. Stat. ch. 111 2/3, § 56 (Smith-Hurd 1966); Mass. Gen. Laws Ann. ch. 164, § 5 (Supp. 1975); Mich. Comp. Laws Ann. §§ 460.502, -.505 (1967); Miss. Code Ann. §§ 77-3-11, -13 (1972); Mo. Ann. Stat. § 393.170 (Vernon's Supp. 1975); N.J. Stat. Ann. § 48:2-14 (1969); N.Y. Pub. Serv. Law § 68 (McKinney 1955); Pa. Stat. Ann. tit. 66, § 1121 (Supp. 1975); Va. Code Ann. §§ 56-265.2, -265.3 (1974); Wis. Stat. Ann. § 196.49 (Supp. 1975); Wyo. Stat. Ann. § 37-31 (1959).

[47] *See* State Util. Comm'n v. Heater Util., 216 S.E.2d 487 (N.C. Ct. App. 1975); *Re* Town of Wheatland, 76 P.U.R.3d 113, 122 (Wyo. Pub. Serv. Comm'n 1968).

[48] Meeks, *supra* note 46, at 97.

our public utilities. In the electric utility industry, for example, a certificated area allows increased production of electricity within that area which results in a decrease in the total unit cost of electricity.[49] The words of Justice Brandeis, dissenting in *New State Ice Co. v. Liebmann,*[50] demonstrate this principle:

> The Oklahoma statute makes entry into the business of manufacturing ice for sale and distribution dependent, in effect, upon a certificate of public convenience and necessity. Such a certificate was unknown to the common law. It is a creature of the machine age, in which plants have displaced tools and businesses are substituted for trades. The purpose of requiring it is to promote the public interest by preventing waste. Particularly in those businesses in which interest and depreciation charges on plant constitute a large element in the cost of production, experience has taught that the financial burdens incident to unnecessary duplication of facilities are likely to bring high rates and poor service. There, cost is usually dependent, among other things, upon volume; and division of possible patronage among competing concerns may so raise the unit cost of operation as to make it impossible to provide adequate service at reasonable rates. The introduction in the United States of the certificate of public convenience and necessity marked the growing conviction that under certain circumstances free competition might be harmful to the community and that, when it was so, absolute freedom to enter the business of one's choice should be denied.[51]

The purpose of regulation and the issuance of certificates of convenience and necessity, however, should be neither to foster monopoly nor to prohibit competition; rather, it should be to protect and promote the public interest.[52] In view of the considerable inconsistency in court and regulatory commission decisions regarding the degree of competition which should be permitted in certificated areas, particularly in relation to electric utilities, a question arises whether this purpose has been achieved.[53] This inquiry will be treated later in more detail.[54]

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[49] *See* Comment, *Regulation, Competition, and Your Local Power Company,* 1974 UTAH L. REV. 785, 787 n.17.

[50] 285 U.S. 262, 280 (1932)(Brandeis, J., dissenting).

[51] *Id.* at 281-82 (footnote omitted).

[52] 1 A. PRIEST, PRINCIPLES OF PUBLIC UTILITY REGULATION 349 (1969); F. WELCH, *supra* note 27, at 76; *see* Miller Bros., Inc. v. Colorado Pub. Util. Comm'n, ___ Colo. ___, 525 P.2d 443 (1974); *Re* Crouse Cartage Co., Docket No. H-5061 (Iowa Commerce Comm'n, May 17, 1974); *In re* Application No. 30466, 194 Neb. 55, 240 N.W.2d 190, 196 (1975); *cf.* BH Transfer Co. v. United States, 379 F. Supp. 1027 (M.D. Ga. 1974); Harbor Carriers, Inc. v. California Inland Pilots Ass'n, 91 P.U.R.3d 218 (Cal. Pub. Util. Comm'n 1971).

[53] *Cf.* Comment, *supra* note 49, at 804.

[54] *See* section IV *A, infra.*

A. *General Characteristics of the Certificate of Public Convenience and Necessity and the Service Area*

The criteria for granting a certificate of public convenience and necessity to operate in an area or in a particular fashion vary with each state. There are, however, general principles which appear to apply uniformly.

In applying for a certificate of public convenience and necessity to operate in an area, a utility obviously must prove that such service is required by public convenience and necessity; failure to do so will result in denial of the certificate.[55] Before granting the certificate, a commission must find that the utility is fit, willing, and able to service the area as the present or future needs require.[56] The commission will consider the size of the proposed service area and the utility's ability to adequately serve the area.[57] Thus, the mere fact that a utility is the first to apply for a certificate does not entitle it to priority over another utility.[58] Another factor which the commission should consider is the long-range public interest that will be affected by the proposed service.[59] Economic considerations such as the utility's debt-to-equity ratio,[60] or whether the proposed service is economically feasible or can be rendered with a small amount of investment,[61] may be determinative in granting or refusing a certificate. The commission should also consider existing property rights of persons who will be affected by proposed construction of facilities.[62]

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[55] Western Colo. Power Co. v. Colorado Pub. Util. Comm'n, 159 Colo. 262, 411 P.2d 785, 806, *appeal dismissed,* 385 U.S. 22 (1966).

[56] *E.g., In re* Charley's Tour and Transp., Inc., 55 Haw. 463, 522 P.2d 1272 (1974); Application of Robinson, 188 Neb. 474, 197 N.W.2d 633, 635 (1972).

[57] *See* Decatur County Rural Elec. Membership Corp. v. Public Serv. Co., 150 Ind. App. 193, 275 N.E.2d 857, 862 (1971); F. WELCH, *supra* note 27, at 76.

[58] Tamiami Trail Tours, Inc. v. Florida Pub. Serv. Comm'n, 308 So. 2d 30, 31 (Fla. 1975). *But cf.* East Miss. Elec. Power Ass'n v. Mississippi Power Co., 251 Miss. 310, 169 So. 2d 473 (1964).

[59] *See* United Cities Gas Co. v. Illinois Commerce Comm'n, 48 Ill. 2d 36, 268 N.E.2d 32 (1971). In such cases the utility will have to show the probable growth of the area. *In re* Board of Fire Comm'rs, 27 N.J. 192, 196, 201, 142 A.2d 85, 87, 89-90 (1958); Milwaukee Suburban Transp. Corp. v. Wisconsin Pub. Serv. Comm'n, 267 Wis. 144, 64 N.W.2d 856 (1954).

[60] *E.g., Re* Dixie Rural Elec. Ass'n, 64 P.U.R.3d 481 (1966); *cf.* Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 147-48, 125 So. 2d 739, 741 (1961).

[61] *See* Illinois Pub. Serv. Co. v. Egyptian Elec. Cooperative Ass'n, 63 P.U.R.3d 110 (Ill. Commerce Comm'n 1966); *Re* American Gas Co., 66 P.U.R.3d 188 (Wis. Pub. Serv. Comm'n 1966).

[62] *See Re* Commonwealth Edison Co., 90 P.U.R.3d 433, 437-38 (Ill. Commerce Comm'n 1971).

In deciding on an application to construct a nuclear power plant, the commission should consider: (1) recommendations of local government; (2) the need to meet present and future demands; (3) the effect on system stability; (4) economic factors; (5) aesthetic

Once a utility has obtained a certificate, it has the right to serve all future needs of the area[63] and the right to earn a reasonable rate of return for its investors.[64] The certificate becomes a property right in itself which may not be interfered with by competitors without commission authority.[65] Commensurate with rights arising from the certificate is the utility's duty to render adequate service within the area,[66] not to unjustly discriminate in service,[67] and to serve all within the certificated area who apply for service.[68] However, the utility's duty to service the area is not perpetual, but exists only so long as public need warrants its continuance.[69] Generally, while it enjoys the benefits of its certificate, no public utility may discontinue services in the area, even if unprofitable, unless such operations impose a financial burden on customers who make up the loss for the unprofitable service.[70] If service has been abandoned, the commission may order restoration of services[71] or revoke the utility's certificate.[72] Abandonment or inadequacy of service is excused only when it is due to faults of the customer (such as destruction of facilities), natural disasters, labor-management controversies, supply shortages, or lack of financial resourses.[73] To venture outside the certificated area, the utility must seek and obtain another certificate for the particular service desired to be rendered.[74]

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factors; and (6) pollution. *See Re* Baltimore Gas & Elec. Co., 88 P.U.R.3d 118, 135 (Md. Pub. Serv. Comm'n 1971).

[63] *E.g.*, Colorado Pub. Util. Comm'n v. Home Light & Power Co., 163 Colo. 72, 428 P.2d 928, 936 (1967); Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 150-52, 125 So. 2d 739, 743 (1961).

[64] *E.g.*, FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944); State Util. Comm'n v. Heater Util., 216 S.E.2d 487, 490 (N.C. Ct. App. 1975); Lovejoy, *supra* note 30, at 305.

[65] *See, e.g.*, Mississippi Power & Light Co. v. City of Clarksdale, 288 So. 2d 9 (Miss. 1974); Payne v. Jackson City Bus Lines, Inc., 220 Miss. 180, 70 So. 2d 520 (1954); 1 A. PRIEST, *supra* note 52, at 230. *But cf.* Frost v. Corporation Comm'n, 278 U.S. 515, 520-21 (1928).

A certificate of public convenience and necessity is, however, subject to seizure for failure to pay federal withholding taxes. Mirin v. Clark County Taxicab Authority, 90 Nev. 46, 518 P.2d 597, *cert. denied*, 419 U.S. 859 (1974).

[66] C. PHILLIPS, THE ECONOMICS OF REGULATION 81 (1965); 1 A. PRIEST, *supra* note 52, at 234-35; Lovejoy, *supra* note 30, at 304.

[67] C. PHILLIPS, *supra* note 66, at 81; 1 A. PRIEST, *supra* note 52, at 228; Lovejoy, *supra* note 30, at 303.

[68] C. PHILLIPS, *supra* note 66, at 81; Lovejoy, *supra* note 30, at 303.

[69] *Re* Valley Rys., P.U.R. 1923A 193 (Pa. Pub. Serv. Comm'n 1923).

[70] F. WELCH, *supra* note 27, at 225-26.

[71] *Id.*

[72] Meeks, *supra* note 46, at 69; *see* Roy v. Illinois Commerce Comm'n, 322 Ill. 452, 153 N.E. 648 (1926).

[73] *See generally* 1 A. PRIEST, *supra* note 52, at 237-44.

[74] MISS. CODE ANN. § 77-3-11(1)(1972); *see* Western Pa. Water Co. v. Pennsylvania, 10 Pa. Commw. 533, 311 A.2d 370 (1973). *Contra*, Pub. Serv. Comm'n v. Nevada-

B. State Regulatory Policy

The United States Supreme Court announced in *Nebbia v. New York*[75] that "a state is free to adopt whatever economic policy may reasonably be deemed to promote the public welfare, and to enforce that policy by legislation adapted to its purpose."[76] The state formulates such policy with regard to public utilities largely through statutory provisions concerning certificates of public convenience and necessity.[77] Although there are various forms and divisions of authorities regarding certificates of public convenience and necessity,[78] the certificate's essential function is to prevent or limit duplication and competition upon the assumption that these would bring about high rates and poor services to the detriment of the public.[79] As utilities are to an extent granted a monopoly in their respective service areas, the certificate of public convenience and necessity is a primary vehicle of state regulation.[80] In the electric power industry this principle has been manifested in distribution systems which are usually geographically separated with one utility serving one area.[81] The extent to which a state commission, under statutory authority, is willing to protect this geographical "monopoly" defines the particular regulatory policy to which that state adheres.[82]

There are two basic views concerning the degree to which utility competition should be restricted: "regulated monopoly" and "regulated competition."[83] The "regulated monopoly" concept excludes all competition within the service area which would duplicate the already existing service provided by a certificated utility.[84] The public interest is believed to be served more efficiently and economically so long as the existing utility provides adequate service.[85] Therefore, in a regulated monopoly state, the utility seeking entrance to another utility's certificated area must show that the existing utility's service is inadequate to the extent that it is absolutely necessary to replace the existing service

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California Power Co., P.U.R. 1915F 592 (Nev. Pub. Serv. Comm'n 1915). *See also Re* Moon Lake Elec. Ass'n, 78 P.U.R.3d 355 (Utah Pub. Serv. Comm'n 1969).

[75] 291 U.S. 502 (1934).

[76] *Id.* at 537.

[77] *See generally* 1 A. PRIEST, *supra* note 52, at 361; Smyser, *supra* note 45.

[78] *See* note 46 *supra;* 1 A. PRIEST, *supra* note 52, at 353.

[79] New State Ice Co. v. Liebmann, 285 U.S. 262, 280 (1932) (Brandeis, J., dissenting).

[80] 1 A. PRIEST, *supra* note 52, at 348-49.

[81] Meeks, *supra* note 46, at 68.

[82] *Cf.* City of Calhoun v. North Ga. Elec. Membership Corp., 233 Ga. 759, 213 S.E.2d 596 (1975)(state legislature free to restrict competition among public utilities where competition is injurious to existing service).

[83] *See generally* 1 A. PRIEST, *supra* note 52; Smyser, *supra* note 45.

[84] 1 A. PRIEST, *supra* note 52, at 361-62; Smyser, *supra* note 45, at 29.

[85] See authorities cited note 84 *supra.*

with that of the invading utility.[86] When a court holds that competition among natural monopolies is per se wasteful and results in poor service, it is embracing the rationale of regulated monopoly.[87]

The concept of "regulated competition," on the other hand, denies that certain utilities are, by necessity, natural monopolies in the "usual regulatory sense,"[88] and holds that competition within a particular area is advisable whenever economically feasible.[89] Under the regulated competition theory, the commission will allow additional service in an area even though existing service is adequate when the business volume of the area is such that two utilities can operate without detriment to the other or to the public.[90] Therefore, a regulated competition state would authorize an invasion into a certificated area by a competing utility if there is enough business for the existing utility and the invader to operate without adversely affecting the public.[91] The public convenience and necessity test is thus reduced to "reasonable" necessity.[92] The invader need show only that the existing utility's service is inadequte *or* that the volume of business warrants the services of an additional utility in the area. In a regulated monopoly state, the invader has the much greater burden of proving the inadequacy of service of the existing utility within the certificated area.[93]

A state generally formulates its regulatory policy concerning the extent of monopolization by two methods: (1) its statute governing the issuance of certificates of public convenience and necessity; and (2) state supreme court decisions delimiting the protection afforded certificated areas.[94]

At least two states have statutes declaring that competition will be allowed within a certificated area.[95] The courts of Arizona,[96] Colorado,[97]

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[86] 1 A. PRIEST, *supra* note 52, at 361-62; Smyser, *supra* note 45, at 29, 33.

[87] 1 A. PRIEST, *supra* note 52, at 362 n.61 and accompanying text; *see, e.g.*, Arizona Corp. Comm'n v. Arizona Superior Court, 105 Ariz. 56, 459 P.2d 489 (1969); Western Colo. Power Co. v. Colorado Pub. Util. Comm'n, 159 Colo. 262, 411 P.2d 785, *appeal dismissed*, 385 U.S. 22 (1966).

[88] 1 A. PRIEST, *supra* note 52, at 365.

[89] *Id.*

[90] Smyser, *supra* note 45, at 38.

[91] 1 A. PRIEST, *supra* note 52, at 362; Smyser, *supra* note 45, at 29, 33.

[92] Smyser, *supra* note 45, at 29; *see, e.g.*, John Gibbons, Inc. v. Pennsylvania Pub. Util. Comm'n, 18 Pa. Commw. 173, 334 A.2d 806 (1975)(must show reasonable necessity for intrusion); Morgan Drive Away, Inc. v. Pennsylvania, 16 Pa. Commw. 293, 328 A.2d 194 (1974)(must show reasonable necessity).

[93] Smyser, *supra* note 45, at 30.

[94] *See generally id.*

[95] ILL. ANN. STAT. ch. 111 2/3, § 56 (Smith-Hurd 1966); MO. REV. STAT. § 390.051(6) (Supp. 1975) (limited to common carriers).

[96] Arizona Corp. Comm'n v. Arizona Superior Court, 105 Ariz. 56, 459 P.2d 489 (1969)(regulated monopoly for common carriers); Arizona Corp. Comm'n v. People's

and Nebraska[98] have adopted a "regulated monopoly" policy. On the other hand, the Supreme Court of Utah has declared that regulated monopoly is not the strict policy of that state,[99] while Missouri has placed common carriers in the category of "regulated competition"[100] and electric utilities in that of "regulated monopoly."[101] The regulatory policies of the remaining states may be ascertained by examining court decisions which deal with conflicts between existing certificated utilities and intruders.[102] Of course, as will be seen by reviewing decisions involv-

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Freight Lines, Inc., 41 Ariz. 158, 16 P.2d 420 (1932)(regulated monopoly for all public utilities).

[97] Rocky Mountain Airways, Inc. v. Colorado Pub. Util. Comm'n, 181 Colo. 170, 509 P.2d 804 (1973)(regulated monopoly as a state policy); Western Colo. Power Co. v. Colorado Pub. Util. Comm'n, 159 Colo. 262, 411 P.2d 785, 790, *appeal dismissed,* 385 U.S. 22 (1966) (regulated monopoly for electric utilities); Denver & R.G.W.R.R. v. Colorado Pub. Util. Comm'n, 142 Colo. 400, 351 P.2d 278, 280 (1960); Archibald v. Public Util. Comm'n, 115 Colo. 90, 171 P.2d 421 (1946) (state policy).

[98] Moritz v. Transcontinental Bus Lines, 153 Neb. 206, 43 N.W.2d 603 (1950) (state policy).

[99] Union Pacific R.R. v. Public Util. Comm'n, 103 Utah 459, 135 P.2d 915, 918 (1943)(regulated competition is as much within the act as regulated monopoly).

[100] State v. Public Serv. Comm'n, 240 Mo. App. 603, 211 S.W.2d 547, 551 (1948).

[101] Missouri Pub. Serv. Co. v. City of Trenton, 509 S.W.2d 770 (Mo. Ct. App. 1974).

[102] For application of the regulated monopoly concept, *see* Public Serv. Co. v. Hamil, 416 F.2d 648 (7th Cir. 1969), *cert. denied,* 396 U.S. 1010 (1970); Smith Transfer Co. v. Alabama Pub. Serv. Comm'n, 271 Ala. 177, 123 So. 2d 28 (1960); Corporation Comm'n v. Pacific Motor Trucking Co., 100 Ariz. 87, 412 P.2d 33 (1966); Southwestern Elec. Power Co. v. Coxey, 257 Ark. 534, 518 S.W.2d 485 (1975); Arkansas-Best Freight Sys. v. Missouri Pac. Truck Lines, 240 Ark. 664, 401 S.W.2d 571 (1966); Public Serv. v. Colorado Pub. Util. Comm'n, 174 Colo. 470, 485 P.2d 123 (1971); Commercial Carrier Corp. v. Mason, 177 So. 2d 337 (Fla. 1965); Illinois Highway Transp. Co. v. Commerce Comm'n, 404 Ill. 610, 90 N.E.2d 86 (1950); General Communications Sys., Inc. v. Kansas State Corp. Comm'n, 532 P.2d 1341 (Kan. 1975); Communications Indus., Inc. v. Louisiana Pub. Serv. Comm'n, 260 La. 1, 254 So. 2d 613 (1971); Clark v. Public Serv. Comm'n, 209 Md. 121, 120 A.2d 363 (1955); Ferguson-Steere Motor Co. v. State Corp. Comm'n, 63 N.M. 137, 314 P.2d 894 (1957); Owens Motor Freight v. Ohio Pub. Util. Comm'n, 50 Ohio St. 2d 253, 215 N.E.2d 393 (1966); Railroad Comm'n v. National Transp. Co., 363 S.W.2d 364 (Tex. Civ. App. 1962); Utah-Wycoff Warehouses, Inc. v. Public Serv. Comm'n, 16 Utah 2d 431, 403 P.2d 168 (1965); Northern Pac. Transp. Co. v. Washington Util. & Transp. Comm'n, 69 Wash. 2d 472, 418 P.2d 735 (1966); Charleston Transit Co. v. Public Serv. Comm'n, 142 W. Va. 750, 98 S.E.2d 437 (1957).

For application of the regulated competition concept, *see* REA v. Central La. Elec. Co., 354 F.2d 859 (5th Cir. 1966); Slay Transp. Co. v. United States, 353 F. Supp. 555 (E.D. Mo. 1973); Chandler Trailer Convoy, Inc. v. Wood, 251 Ark. 966, 479 S.W.2d 515 (1972); Dion v. Public Util. Comm'n, 24 Conn. Supp. 403, 192 A.2d 46 (1963); Wetmore v. Bevis, 312 So. 2d 722 (Fla. 1974); Application of Ford L. Johnson Oil Co., 84 Idaho 288, 372 P.2d 135 (1962); Northfield Woods Water & Util. Co. v. Illinois Commerce Comm'n, 28 Ill. App. 3d 664, 329 N.E.2d 295 (1975); Southern Ind. Gas & Elec. Co. v. Indiana Statewide Rural Elec. Cooperative, 251 Ind. 457, 242 N.E.2d 361 (1969); Kentucky Util. Co. v. Farmers Rural Elec. Cooperative, 362 S.W.2d 498 (Ky. 1962); Gulf States Util. Co.

ing competition between utilities, particularly in the electric utility industry, many states are quite inconsistent in applying regulatory rules.[103] The lack of a uniform regulatory policy, resulting from commission and court decisions, has caused many observers to conclude that the state regulations of public utilities is ineffective.[104]

III. Mississippi Regulatory Policy, Electric Utilities, and the Ghost of *Tri-State Transit*

An inquiry into Mississippi regulatory policy as it applies to the electric utility industry may begin with an examination of statutory provisions regarding the certificate of public convenience and necessity[105] to determine the extent the statute protects an electric utility from competition within its certificated area. Section 77-3-21 of the Mississippi Code provides:

> The commission may, after a hearing had upon due notice, make such findings as may be supported by proof as to whether any utility holding a certificate under the provisions of this article is rendering reasonably adequate service in any area covered by such utility's certificate. In the event the commission finds that such utility is not rendering reasonably adequate service the commission may enter an order specifying in what particulars such utility has failed to render reasonably adequate service and order that such failure be corrected within a reasonable time, such time to be fixed in such order. If . . . the commission finds that cancel-

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v. Jefferson Davis Elec. Cooperative, 230 So. 2d 273 (La. 1969); Daklen Transp., Inc. v. Hane, 261 Minn. 218, 112 N.E.2d 630 (1961); City of Sikeston v. Public Serv. Comm'n, 33 Mo. 985, 82 S.W.2d 105 (1935); Application of Greenville Bus Co., 17 N.J. 131, 110 A.2d 122 (1954); North Carolina *ex rel.* Util. Comm'n v. Lumbee River Elec. Membership Corp., 275 N.C. 250, 166 S.E.2d 663 (1969); Oklahoma Gas & Elec. Co. v. Oklahoma Elec. Cooperative, Inc., 517 P.2d 1127 (Okla. 1973); John Gibbons, Inc. v. Pennsylvania Pub. Util. Comm'n, 18 Pa. Commw. 173, 334 A.2d 806 (Pa. 1975); Blue Ridge Transp. Co. v. Pentecost, 208 Tenn. 94, 343 S.W.2d 903 (1961).

[103] Many states apply rules of regulated competition in one particular fact situation, and rules of regulated monopoly in others. *E.g., compare* Southwestern Elec. Power Co. v. Coxsey, 257 Ark. 534, 518 S.W.2d 485 (1975), *with* Chandler Trailer Convoy, Inc. v. Wood, 251 Ark. 966, 479 S.W.2d 515 (1972), *and* Commercial Carrier Corp. v. Mason, 177 So. 2d 337 (Fla. 1965), *with* Wetmore v. Beris, 312 So. 2d 722 (Fla. 1974), *and* Northfield Woods Water & Util. Co. v. Illinois Commerce Comm'n, 28 Ill. App. 3d 664, 329 N.E.2d 295 (1975), *with* Illinois Highway Transp. Co. v. Commerce Comm'n, 404 Ill. 610, 90 N.E.2d 86 (1950).

[104] R. Hellman, Government Competition in the Electric Utility Industry 43 (1972); Stigler & Friedland, *What Can Regulators Regulate? The Case of Electricity*, 5 J. Law & Econ. 1, 11 (1962). *See also* Miller, *A Needed Reform of the Organization and Regulation of the Interstate Electric Power Industry*, 38 Fordham L. Rev. 635, 670 (1970); Bray, *Feeling the Heat: Workloads, Criticism Grow for Regulators as Utility's Rates Rise*, Wall Street Journal, Jan. 28, 1975, at 1, col. 6, 26, col. 3.

[105] Public Utilities Act § 5, Miss. Code Ann. §§ 77-3-11 to -21 (1972).

> lation of its certificate would be in the best interest of the consuming public served by the holder of the certificate, *its certificate for the area affected may be revoked and cancelled by the commission.*[106]

A literal reading of this section indicates that the regulated monopoly concept is adopted even though competition within a certificated area is not expressly prohibited. As previously noted,[107] the regulated monopoly theory protects a utility's right to serve its certificated area so long as it renders adequate service. The utility may be divested of this right only upon a showing that existing service is so inadequate that it must be *replaced.*[108] Accordingly, the statute permits an electric utility to operate in "any area" covered by its certificate so long as its service is reasonably adequate. If, after the commission finds existing service inadequate and orders it to be upgraded, the certificated utility cannot render adequate service, the commission may revoke the certificate. This would seem to satisfy the "absolutely necessary" test embraced by the regulated monopoly concept.[109] In its practical application, however, the effect of this statute is that no electric utility may secure duplicating rights in any area being served by a certificated electric utility if its application is protested by the certified utility.[110] Obviously, any electric utility with average financial means would be able to demonstrate its ability to meet any alleged deficiency in service. This gives the certificated electric utility a second line of defense against a prospective competitor, greatly enhancing the argument that Mississippi legislative policy respecting the electric utility industry is that of regulated monopoly. However, an examination of cases resolving conflicts between competing electric utilities shows that Mississippi statutory authority is anything but dispositive of state regulatory policy.

The electric utility industry in Mississippi is composed of three types of entities: Investor-owned (privately owned), government-owned (municipally owned), and rural cooperatives.[111] The legislature granted the public service commission authority, with certain exceptions, to regulate all intrastate electric utilities.[112] While the commission has full

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[106] Miss. Code Ann. § 77-3-21 (1972)(emphasis added).

[107] See text accompanying notes 83 through 87 *supra.*

[108] See note 86 and accompanying text *supra.*

[109] *Id.*

[110] *See* Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 125 So. 2d 739 (1961).

[111] *See generally* Meeks, *supra* note 46, at 67.

[112] Miss. Code Ann. § 77-3-5 (1972), provides in part:

> Subject to the limitations imposed in this article and in accordance with the provisions hereof, the public service commission shall have exclusive original jurisdiction over the intrastate business and property of public utilities.

Miss. Code Ann. § 77-3-3(d)(1972) defines "public utility" as

authority over privately owned electric utilities, it has only partial jurisdiction over rural cooperatives since state regulation of sales of electricity by cooperatives is expressly exempted.[113] Although municipally owned electric utilities are excluded from commission jurisdiction, except as to service more than one mile outside corporate limits,[114] any privately owned company or cooperative which provides electricity in a municipality pursuant to a municipal franchise[115] is subject to regulation.[116]

All three types of electric utilities—municipally owned, privately owned, and cooperatives—compete with each other for customers both at the retail[117] and wholesale[118] level. Conflicts resulting from this competition manifest themselves in three different factual situations: (1) competition between regulated electric utilities operating outside municipal boundaries; (2) competition between a regulated utility operating in a city under a municipal franchise and a regulated utility either bordering the municipality or operating in the same municipality under a like franchise; and (3) competition between regulated utilities and municipally owned electric utilities which do not fall within the ambit of state regulation. Because municipally owned electric utilities operating within municipal boundaries are excluded from commission regulation,[119] special problems arise from competition between municipally owned utilities and regulated utilities. Therefore, for purposes of analyzing Mississippi regulatory policy in the electric utility industry, treat-

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persons and corporations, or their lessees, trustees and receivers now or hereafter owning or operating in this state equipment or facilities for: (1) the generation, manufacture, transmission or distribution of electricity to or for the public for compensation . . . .

[113] *Id.* § 77-3-5(b)(1972); *see* Capital Elec. Power Ass'n v. McGuffee, 226 Miss. 227, 242, 83 So. 2d 837, 842 (1955). *See also* Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 125 So. 2d 739 (1961).

[114] MISS. CODE ANN. § 77-3-1 (1972); *see* Mississippi Power Co. v. East Miss. Elec. Power Ass'n, 244 Miss. 40, 46-47, 140 So. 2d 286, 287 (1962); *cf.* Jackson v. Creston Hills, 252 Miss. 564, 172 So. 2d 215 (1965).

[115] No electric utility may obtain a certificate of public convenience and necessity to serve customers within a municipality without having first obtained a franchise from the municipality, unless the franchise is arbitrarily withheld by the municipal authority. MISS. CODE ANN. § 77-3-19 (1972).

[116] *Id.* §§ 77-3-15 to -19 (1972).

[117] *See, e.g.*, East Miss. Elec. Power Ass'n v. Mississippi Power Co., 254 Miss. 832, 182 So. 2d 925 (1966); Mississippi Power Co. v. East Miss. Elec. Power Ass'n, 244 Miss. 40, 140 So. 2d 286 (1962).

[118] *See* Mississippi Power Co. v. South Miss. Elec. Power Ass'n, 254 Miss. 754, 183 So. 2d 163, *cert. denied*, 385 U.S. 823 (1966).

[119] MISS. CODE ANN. §§ 77-3-1, -15 (1972).

ment of municipally owned and operated electric utilities will be excluded from this article.

A. Regulated Electric Utilities Operating Outside Municipal Boundaries: The Elton *Case*

The Public Utilities Act of 1956[120] brought electric utilities operating in Mississippi within public service commission jurisdiction for the first time.[121] The act contained a provision which allowed utilities providing service or constructing facilities at the time the act was passed to apply for and receive a certificate for their existing service areas without having to prove "public convenience and necessity."[122] This provision became known as the "grandfather clause," and electric utilities obtaining certificates under this section were said to have procured "grandfather certificates."[123] Early conflicts arose in disputes over the characteristics of, and rights possessed under, the "grandfather certificate."

The most significant case arising soon after enactment of the 1956 Act was *Capital Electric Power Association v. Mississippi Power & Light Co.*[124] (*Elton*). Mississippi Power and Light (MP&L) applied to the public service commission for a certificate of public convenience and necessity to build facilities which would allow it to supply electricity to a woodchipping plant located in south Jackson.[125] MP&L, prior to filing its application, had contracted to render such service. Pursuant to the "grandfather clause" of the 1956 Act, however, when MP&L applied for a certificate of public convenience and necessity, its service area map filed with the commission did not include the land surrounding the plant.[126] Instead, Capital Electric Power Association, which had been

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[120] Act of March 29, 1956, ch. 372, [1956]Gen. Laws Miss. 531, *codified in* MISS. CODE ANN. §§ 77-3-1 *et seq.* (1972).

[121] Delta Elec. Power Ass'n v. Mississippi Power & Light Co., 250 Miss. 482, 497, 149 So. 2d 504, 507 (1963).

[122] MISS. CODE ANN. § 77-3-13 (1972), provides in part:

> The commission shall issue a certificate of convenience and necessity to any person engaged in the construction or operation of such equipment or facility . . . on March 29, 1956, for the construction or operation then being conducted, without requiring proof that public convenience and necessity will be served by such construction or operation . . . if application for such certificate shall have been made to the commission within six months after said date.

[123] *See, e.g.*, Mississippi Power Co. v. East Miss. Elec. Power Ass'n, 244 Miss. 40, 46, 140 So. 2d 286, 287 (1962); Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 152, 125 So. 2d 739, 744 (1961); Mississippi Power & Light Co. v. Blake, 236 Miss. 207, 212-13, 109 So. 2d 657, 658 (1959).

[124] 240 Miss. 139, 125 So. 2d 739 (1961).

[125] *Id.* at 145, 125 So. 2d at 740.

[126] *Id.*

serving the area for 17 years, had filed with its application for a grandfather certificate a map embracing the entire area surrounding the plant.[127] The closest permanent transmission line owned by MP&L was 0.35 miles from the plant, while Capital Electric operated a line within 18 feet of the plant.[128] Naturally, Capital Electric protested MP&L's application.

At the certification hearing MP&L contended that it would actually be able to render more dependable service at cheaper rates, and that Capital Electric would seriously impair its service to existing customers if it provided service to the plant.[129] Moreover, the plant manager testified that, upon recommendations from a "competent electrical engineer," the plant desired MP&L service and that past experience with the cooperative had convinced him that Capital Electric could not handle the job.[130] Capital Electric's witnesses testified that, while it could not then match MP&L's capacity load, it was upgrading its system to meet capacity demands such as the one in dispute.[131] Capital Electric also pointed out that it could render electricity at a rate 10 percent lower than MP&L and that it had a lower debt-to-equity ratio which made it financially stronger.[132]

After having heard the evidence, the commission granted the certificate to MP&L, stating that "Capital Electric . . . does not have and is not in position to construct adequate facilities to efficiently serve . . . the [plant]."[133] The commission also approved MP&L's contract with the plant. The commission's order was appealed to the Chancery Court of the First Judicial District of Hinds County, which affirmed the commission.[134]

On appeal, the Mississippi Supreme Court reversed and remanded to the commission,[135] holding that

> [a]n existing utility within the certificated area has the right and duty to provide the service, and must be given that opportunity. If it fails, the commission can award another franchise to another utility.[136]

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[127] *Id.*

[128] *Id.* at 146, 125 So. 2d at 741.

[129] *Id.* MP&L would have been able to render a much stronger 3-phase power while Capital Electric, at that time, was rendering only 2-phase power through its lines. Although Capital Electric demonstrated that it was willing to upgrade its transmissions to 3-phase power, even doing so would not prevent energy drainage by the plant from affecting Capital Electric's residential customers. *Id.*

[130] *Id.*

[131] *Id.*

[132] *Id.*

[133] *Id.*

[134] *Id.* at 145-46, 125 So. 2d at 740.

[135] *Id.* at 153, 125 So. 2d at 744.

[136] *Id.* at 151, 125 So. 2d at 743.

The court based its holding on the premise that the legislature had intended that the facilities of one utility in a particular area should not be duplicated and that certificated areas should not overlap.[137] In doing so, the court compared the 1956 Act with the Mississippi Motor Carriers Act[138] and found applicable the rule of *Tri-State Transit Co. v. Dixie Greyhound Lines:*[139]

> The rule is, and we find no authority to the contrary, that a certificate should not be granted where there is existing adequate service over the route applied for, and, if inadequate, unless the existing carrier has been given an opportunity to furnish such additional service as may be required.[140]

The court then applied another rule of law involving common carriers:

> If, at occasional intervals, the service is not perfect or adequate, another franchise should not be granted, if the existing carrier is ready, willing and able to conform to such order as the commission may make in respect to additional facilities.[141]

The court concluded by holding that the granting of certificates of public convenience and necessity to an electric utility falls into the same category as that of common carriers.[142]

The *Tri-State Transit* rule, often called the "existing facility" rule,[143] had its origin in a case decided by the Mississippi Supreme Court in 1944.[144] Dixie Greyhound, operating over Highway 51 between Jackson, Mississippi and Memphis, Tennessee, under a franchise issued by the Interstate Commerce Commission, applied to the Mississippi commission for authority to transport passengers intrastate over the Mississippi portion of the route.[145] Tri-State Transit, which held an intrastate franchise over the same route, protested the application. The commission denied the application.[146] On appeal, the court held that no carrier may secure duplicating rights over the route of any other carrier if the

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[137] *Id.*

[138] MISS. CODE. ANN. §§ 77-7-1 *et seq.* (1972).

[139] 197 Miss. 37, 19 So. 2d 441 (1944).

[140] 240 Miss. at 151, 125 So. 2d at 743.

[141] *Id.* at 151-52, 125 So. 2d at 743, *quoting* Dixie Greyhound Lines v. American Buslines, 209 Miss. 874, 890, 48 So. 2d 584, 587 (1950).

[142] 240 Miss. at 152, 125 So. 2d at 743.

[143] *See* Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 216 So. 2d 428, 430 (Miss. 1968); Mississippi Power Co. v. South Miss. Elec. Power Ass'n, 254 Miss. 754, 768, 183 So. 2d 163, 167, *cert. denied,* 385 U.S. 823 (1966).

[144] Tri-State Transit Co. v. Dixie Greyhound Lines, Inc., 197 Miss. 37, 19 So. 2d 441 (1944).

[145] *Id.* at 44-45, 19 So. 2d at 442.

[146] *Id.* at 45, 19 So. 2d at 442.

application is protested by the existing carrier which can demonstrate that it is able to meet any deficiency in service.[147]

There can be little doubt that the *Tri-State Transit* rule adheres to the regulated monopoly concept. Applying that concept to the electric utility industry, an electric utility, when granted a certificate of public convenience and necessity, is given a complete monopoly within its certificated area, and no other company may provide service in that area unless it can show that existing service is inadequate.[148] The rationale for the rule is that competition results in per se wasteful duplication of facilities.[149]

A troubling aspect of the *Elton* case, however, is that duplication of services and overlap of certificated areas were not involved to the extent the court intimated.[150] The court failed to recognize that an electric utility has different classes of customers—industrial and residential. The distinction is evidenced by the fact that an electric utility may charge industrial customers lower prices than residential customers due to the lower cost of producing electricity for a large consumer.[151] Even under the regulated monopoly concept it appears that, though an electric utility may be given a monopoly within its certificated area to serve residential customers, another utility could be allowed to build facilities in the area to serve a large industrial consumer. This should be especially true if the existing utility's ability to provide the type of service needed by the industrial consumer is in doubt.[152] The facilities erected by an intruder to serve an industrial concern in another utility's certificated area would not in reality be a *wasteful* duplication of existing services because the industrial user receives a different type of service than the ordinary residential consumer. The intruder's transmission lines could be extended solely to the large consumer, thereby becoming "frozen" lines,[153] and no service would be offered to any other customers

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[147] *Id.* at 48, 19 So. 2d at 444.

[148] *See* notes 84 through 87 and accompanying text *supra.*

[149] *See* note 87 and accompanying text *supra. See also* Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 151, 153, 125 So. 2d 739, 743, 744 (1961).

[150] To allow the invasion of Capital Electric's area on account of the desire of the Elton Company, regardless of their reasons therefor, to be served by Mississippi Power & Light Company would lay down a principle which would result in endless duplication and make a shamble of the utility act. Such a policy cannot be countenanced by this Court.

240 Miss. at 153, 125 So. 2d at 744.

[151] *See* Lovejoy, *supra* note 30, at 302.

[152] *See* North Carolina *ex rel.* Util. Comm'n v. Lumbee River Elec. Membership Corp., 275 N.C. 250, 166 S.E.2d 663 (1969); *cf.* Western Power & Gas Co. v. Southeast Colo. Power Ass'n, 164 Colo. 344, 435 P.2d 219 (1967).

[153] *See* Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 216 So. 2d 428, 430 (Miss. 1968).

already being served by the certificated utility.

An analogy may be drawn to the situation where large industrial customers produce their own electricity,[154] a practice which is permitted in Mississippi.[155] Since the electricity is consumed only within the confines of the industrial plant, there is no actual duplication of facilities or services. Perhaps this was foreseen by the drafters of the Public Utilities Act of 1956 when they included a provision allowing the commission to approve contracts for electricity made between utilities and manufacturers which were not supplying their own electricity, "without reference to rates *or other conditions* which may be established or fixed pursuant to other provisions of this article."[156] Pursuant to this statutory grant of authority, the public service commission promulgated rule 7(b) which states:

> Utilities may contract with manufacturers who are not utilities for furnishing utilities service or commodities for use in manufacturing without reference to the rates or other terms or conditions which may be established or fixed pursuant to the Public Utilities Act of 1956. Provided however, that before becoming effective any such contract and the construction or extension of the necessary facilities required therefor shall be approved by the Commission.[157]

If rule 7(b) had been given effect by the court, limited duplication of facilities would have been allowed where the commission felt the public interest would be promoted.[158] Yet, the court dismissed MP&L's argument in *Elton* that such was the proper reading of the Act[159] and held that to allow the proposed service would "result in endless duplica-

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[154] *See* Lovejoy, *supra* note 30, at 302.

[155] The commission has no jurisdiction over anyone who furnishes electricity only to himself since a self-supplier does not fall within the definition of a "public utility." MISS. CODE ANN. § 77-3-3(d)(1972).

[156] *Id.* § 77-3-35 (emphasis added).

[157] Utility Rules of Practice and Procedure 7 (1957). Rule 7 further provides:

> The provisions of the Act will be recognized as paramount to other considerations where there is a conflict.
>
> Wherever practicable, the Commission may give consideration to special circumstances in the particular case where it is shown that the industrial development of the state will be promoted thereby.
>
> In considering cases arising under this rule, the Commission may take into consideration along with other pertinent evidence, the following matters, to-wit:
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> . . . .
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> (6) Whether or not the grant of the application will result in duplication of facilities and, if so, whether or not any such duplication is in the *public interest.*

Id. (emphasis added).

[158] *Id.*

[159] 240 Miss. at 153, 125 So. 2d at 744.

tion and make a shamble of the utility act."[160] In regard to the phrase in the statute, "without reference to . . . other conditions," the court stated:

> One of the probable reasons for this provision by the legislature was that inducements might be held out for industrial development. It is unthinkable that the legislature threw in the expression "or other conditions" with the intention of giving to the commission the power to take away from a utility, which had been serving an area for many years, its right to do so, or to set up a competitor for it, contrary to [its "grandfather" rights] unconditionally granted to the utility.[161]

This, however, is exactly what at least one of the drafters intended.[162] In holding that rule 7(b) was inconsistent with the court's decision,[163] the court evidently placed greater emphasis on the territorial integrity of the existing utility's certificate than on the needs of the public; the commission found that the public would have been better served by allowing MP&L to provide electricity for the plant.[164] As a result of this rigid rule, such certificates are probably better protected in Mississippi than in any other jurisdiction.

As rigid as the existing facility rule would seem to be, it has not been applied uniformly to Mississippi's regulated industries. In addition, certain court-created exceptions, designed to give the rule greater flexibility have made its validity questionable today. For example, just 2 years prior to the *Elton* case, the court sanctioned the commission's decision to allow MP&L to contract for electrical services with an industrial plant located within the grandfather area of a rural cooperative which, admittedly, could not adequately serve the needs of the plant.[165] The court's passive acceptance of limited duplication in that case does not square with the *Elton* rationale except that the "grandfather holder" in *Elton* protested the proposed service.

A somewhat similar situation arose in *Mississippi Power & Light Co. v. Delta Electric Power Association*.[166] MP&L had been supplying Greenville Air Base with electricity by delivering power to a point within the field where the power was then distributed throughout the field by the government. MP&L filed for a grandfather certificate to supply the

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[160] *Id.*

[161] *Id.*

[162] Interview with one of the authors of the Mississippi Public Utilities Act of 1956, in Jackson, Mississippi, Jan. 10, 1976.

[163] 240 Miss. at 153, 125 So. 2d at 744. It is interesting that the court held the rule to be inconsistent with its decision, and not with the 1956 Act.

[164] *Id.*

[165] Mississippi Power & Light Co. v. Blake, 236 Miss. 207, 109 So. 2d 657 (1959).

[166] 252 Miss. 832, 174 So. 2d 356 (1965).

entire air base, which was located on land leased to the federal government.[167] Claiming the right to serve areas within and surrounding the air base, Delta Electric then filed its application for a grandfather certificate.[168] MP&L's request for a certificate was refused on the grounds that the commission "could not force the Government to permit . . . any . . . public utility to serve the area."[169] Although recognizing that a certificate usually should be granted on an area basis,[170] the court held that circumstances may exist making it necessary to "authorize . . . operations on a *facility* basis."[171] Therefore, the court allowed an order preserving the status quo (limited duplicative service) until circumstances warranted certification on an area basis.[172]

In a more recent case, *Electric Power Association v. Mississippi Power & Light Co.*,[173] the court created another exception to the existing facility rule. In this case the court justified limited duplication so that MP&L could provide one of its substations, located within territory certificated to Capital Electric, with auxiliary power. Capital Electric, relying on the *Elton* case, claimed that under the existing facility rule it had the sole right to supply the substation with the auxiliary power and should be given the first opportunity to do so.[174] In affirming the commission's order allowing MP&L to build a "frozen" auxiliary line serving only the substation, the court stated: "We do not think that the existing facility rule is applicable or controlling under these circumstances."[175] Noting that the existing facility rule "should not be used arbitrarily or inflexibly,"[176] the court ruled that MP&L should be allowed to serve its own substation.[177]

Another disturbing facet of the *Elton* case is the court's failure to recognize the distinction between a franchise and a certificate of public convenience and necessity. This failure was apparent when the court stated:

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[167] *Id.* at 837, 174 So. 2d at 357-58.

[168] *Id.*

[169] *Id.* at 837, 174 So. 2d at 358. Some states, however, allow public service commissions to exercise jurisdiction over services provided to federal government facilities located within the state. *See re* Chesapeake & Potomac Tel. Co., 91 P.U.R.3d 437 (Va. Corp. Comm'n 1971). For a discussion of private utilities' operations on United States land, *see* Brandenburg Tel. Co. v. South Cent. Bell Tel. Co., 506 S.W.2d 513 (Ky. Ct. App. 1974).

[170] 252 Miss. at 837, 174 So. 2d at 358.

[171] *Id.* at 838, 174 So. 2d at 359 (emphasis added).

[172] *Id.*

[173] 216 So. 2d 428 (Miss. 1968).

[174] *Id.* at 430.

[175] *Id.*

[176] *Id., quoting* Keith v. Bay Springs Tel. Co., 251 Miss. 106, 118, 168 So. 2d 728, 732 (1964).

[177] 216 So. 2d at 430.

> Having served the electrical requirements in the Elton area for more than 17 years, Capital Electric . . . acquired the right to a *certificate of convenience and necessity* therein, *being in truth and in fact a franchise from the State*. . . . "A nonexclusive franchise is a valuable right which can be protected in the courts."[178]

Before the creation of state regulatory commissions, franchising was the method through which the utility contracted with the state in order to provide service for an area.[179] All regulatory terms, including rates, services, and area, were placed in the contract.[180] The franchise also included terms for duration and renewal, as most were nonperpetual.[181] Although the franchise granted the right to serve an area, it required the utility to provide adequate service to the area.[182] Through the franchise the state attempted to implement direct regulation. This attempt, however, proved ineffectual because of the franchise's inflexibility regarding the technological and regulatory characteristics peculiar to the electric utility industry.[183]

A franchise is a rigid contract between the utility and the state; its terms must be followed by each party,[184] and it cannot be impaired by the state.[185] The certificate of public convenience and necessity, however, is not "in truth and in fact a franchise from the State."[186] Rather, the certificate embraces a much broader concept and was created to replace the ineffective regulation by direct franchise. The court's failure to recognize this subtle distinction indicates a lack of sophistication in approaching the regulation of our public utilities.[187]

Subsequent cases reaffirmed the application of the regulated monopoly concept to electric utilities operating outside municipal boundaries and the court reiterated the rule that certification should be on an area basis[188] and that duplication of facilities and services should

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[178] 240 Miss. 139, 150, 125 So. 2d 739, 743 (1961) (emphasis added), *quoting in part* Mississippi Power & Light Co. v. Mississippi Power Dist., 230 Miss. 594, 611, 93 So. 2d 446, 449 (1957).

[179] C. PHILLIPS, *supra* note 66, at 88.

[180] *Id.*

[181] *Id.*

[182] *See* 1 A. PRIEST, *supra* note 52, at 230-31.

[183] C. PHILLIPS, *supra* note 66, at 89.

[184] M. GLAESER, *supra* note 13, at 37, 75-76; 1 A. PRIEST, *supra* note 52, at 230; *see* Village of Solvay v. Power Authority, 41 App. Div. 2d 892, 34 N.Y. S.2d 747 (1973). *See generally* W. JONES, CASES ON REGULATED INDUSTRIES 30 (2d ed. 1976).

[185] Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 643 (1819).

[186] Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 150, 125 So. 2d 739, 743 (1961).

[187] *See* Lovejoy, *supra* note 30, at 306.

[188] East Miss. Elec. Power Ass'n v. Mississippi Power Co., 254 Miss. 832, 838, 182 So. 2d 925, 926 (1966); Mississippi Power Co. v. East Miss. Power Ass'n, 244 Miss. 40, 48, 140 So. 2d 286, 288 (1962).

be avoided.[189] Moreover, the *Tri-State Transit* "existing facility" rule appeared to be the law.[190]

The impracticality of rigid enforcement of the *Tri-State Transit* rule was demonstrated in *Mississippi Power Co. v. South Mississippi Electric Power Association.*[191] South Mississippi Electric Power Association (the Association), composed of nine rural cooperatives, was organized and operated under the Mississippi Electric Power Association Act.[192] The Association petitioned for a certificate of public convenience and necessity to construct and operate an electric transmission system in southeast Mississippi so it could distribute power to the nine cooperative members.[193] At the time of suit, all nine of the cooperatives purchased all their power from either MP&L or Mississippi Power Company. The wholesale sales made by the two private companies had been allowed by virtue of grandfather certificates granting those companies the right to deliver to the nine cooperatives.[194] These sales made up about 0.32 percent of MP&L's total sales and 4.14 percent of Mississippi Power Company's total sales.[195] Thus it was not surprising that the two companies protested the application, particularly since *Elton* appeared to be dispositive of the suit. Contrary to their protest, however, the commission granted the certificate to the Association.

On appeal, the companies alleged *inter alia* that the order of the public service commission violated the existing facilities rule since certification of the Association authorized "unwarranted duplication of service presently rendered."[196] Furthermore, they alleged that the existing facility rule guaranteed them protection from impairment of their rights under their grandfather certificates, and that they had the right under the 1956 Act to correct any inadequacies which existed before a certificate could be granted to the Association.[197]

Addressing these issues, the court recognized the *Tri-State Transit* existing facility rule and noted that it applied to the issuance of certificates of public convenience and necessity in the electric utility indus-

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[189] East Miss. Elec. Power Ass'n v. Mississippi Power Co., 254 Miss. 832, 838, 182 So. 2d 925, 926 (1966); East Miss. Elec. Power Ass'n v. Mississippi Power Co., 251 Miss. 310, 169 So. 2d 473, 475 (1964); Mississippi Power Co. v. East Miss. Elec. Power Ass'n, 249 Miss. 869, 164 So. 2d 479 (1964).

[190] *See* Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 216 So. 2d 428 (Miss. 1968); Mississippi Power Co. v. South Miss. Elec. Power Ass'n, 254 Miss. 754, 183 So. 2d 163, *cert. denied,* 385 U.S. 823 (1966).

[191] 254 Miss. 754, 183 So. 2d 163, *cert. denied,* 385 U.S. 823 (1966).

[192] MISS. CODE ANN. §§ 77-5-201 to -251 (1972).

[193] 254 Miss. at 764, 183 So. 2d at 165.

[194] *Id.*

[195] *Id.* at 765, 183 So. 2d at 166.

[196] *Id.*

[197] *Id.*

try.[198] The court nevertheless affirmed the commission's order granting the Association a certificate. In so holding, the court relied on *Keith v. Bay Springs Telephone Co.*,[199] where it had discussed the application of *Tri-State Transit* to radio telephones:[200]

> However, the existing facility rule does not apply unless the services and facilities to be rendered by the new certificate are duplicating and result in waste. Section 5(c) of the Public Utility [sic] Act reflects an intent to "prevent unnecessary and uneconomic duplication of such facilities as between two" utilities. . . . The rule is a limitation upon the Commission's power to issue certificates, but it is relevant for the purpose principally of avoiding wasteful duplication of the existing utility service.
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> . . . .
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> In short, the existing facility rule, developed under the Motor Carrier Regulatory Act, has been applied to an electric utility under the 1956 act. But it should not be used arbitrarily or inflexibly. The Commission is given the power to determine "that the present or future public convenience and necessity require or will require the operation of such equipment or facility." . . . This is essentially the determination of a matter of policy, namely, which utility in the opinion of the agency will best serve the public convenience, necessity and welfare.[201]

The court defined the term "wasteful" as that which would

> injure the public or interfere with its interest, growth and development. It must not be a prevention of waste carried to the extreme where it prevents or interferes with progress in equipment or methods or ways of serving the public. And the determination as to whether waste would result, or whether the waste which did result would be so against the public welfare and interest that it should be prevented, are questions for the commission to determine.[202]

The court, in *Keith,* did not ground its holding upon the adequacy *vel non* of existing service. Rather, it found that despite duplication of facilities, certification would be neither uneconomical nor wasteful.[203]

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[198] *Id.* at 767-68, 183 So. 2d at 167.

[199] 251 Miss. 106, 168 So. 2d 728 (1964).

[200] In *Keith,* Bay Springs Telephone Company, operating in an area under a grandfather certificate, filed an application with the commission for a certificate to operate a dial radiotelephone service to subscribers within its certificated area. Keith, doing business as Monroe Radiotelephone Company, protested the application. The court upheld the commission's decision to grant Bay Springs a certificate on the grounds that since the proposed service was essentially different from the service offered by Monroe, there would be no wasteful duplication of services or facilities.

[201] 251 Miss. at 114-18, 168 So. 2d at 730-32.

[202] 254 Miss. at 769-70, 183 So. 2d at 168, *cert. denied,* 385 U.S. 823 (1966), *quoting* Utah Light & Traction Co. v. Public Serv. Comm'n, 101 Utah 99, 118 P.2d 683, 690 (1941).

[203] 251 Miss. at 114, 168 So. 2d at 730.

This represented a drastic change in the court's approach to conflicts between two competing utilities. The new approach was an expression of the regulated competition concept, which, as previously mentioned, is based on the premise that additional service in another utility's certificated area is permissible if that area's volume of business would allow the intruding utility to operate without detriment to the existing utility or to the public.[204]

This premise was a major reason for the court's holding in *South Mississippi.*[205] In reaching its decision that the duplication of lines in the companies' certificated areas would not be uneconomical or wasteful, the court relied on the commission's findings that due to large generating capacities and interconnections, the two companies had increased their business: MP&L by 39.2 percent and Mississippi Power by 49.1 percent. In addition, the nine members of the Association had increased their total sales by 262.43 percent. Based on these figures, the commission had held that the proposed system would not result in uneconomic duplication of facilities, stating: "Only in a few instances would the transmission lines of petitioner's proposed service physically parallel those of protestants."[206] The commission had also found that during the years preceding the litigation there had been a "constant need for additional generating and transmission facilities" within the state[207] and, despite the "splendid interconnections" with other systems by the companies, there was a need for increased generating capacity and facilities.[208] Regarding these findings, the court said:

> In candor we should state that the commission has not found the services of either of the protestants to be inadequate, but rather found, as noted, *there was a need for additional generating capacity broad enough to encompass the . . . generating facility authorized.* Under these circumstances (a deficit of generating capacity) we are of the opinion that the commission properly held the needs of the public above the grandfather certificates of the [companies] . . . .[209]

Regardless of the court's attempt to base its decision on a deficit in generating capacity, there is no denying that the rationale can be reduced to one factor: There was enough business for the existing utilities and their competitor to operate without adversely affecting either the public or each other. In line with the regulated competition concept, the Association was granted its certificate because it could show that the

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[204] See notes 88 through 91 and accompanying text *supra.*

[205] 254 Miss. 754, 183 So. 2d 163, *cert. denied,* 385 U.S. 823 (1966).

[206] *Id.* at 772, 183 So. 2d at 169.

[207] *Id.* at 774, 183 So. 2d at 170.

[208] *Id.*

[209] *Id.*(emphasis added).

volume of business warranted additional facilities and service in the area.[210]

In order to appreciate this departure from the *Elton* rationale, *Keith v. Bay Springs Telephone Co.*,[211] upon which *South Mississippi* heavily relied, should be examined. Bay Springs Telephone Company had been operating under a certificate as a land telephone company. When it proposed a mobile dial radiotelephone service and applied for a certificate of public convenience and necessity, Monroe Radiotelephone Company protested.[212] Although the service area proposed by Bay Springs overlapped the area already served by Monroe, the commission granted the certificate. On appeal, stating that the *Tri-State Transit* rule had no application, the Mississippi Supreme Court upheld the commission.[213] The court began discussion of the existing facility rule by noting that its original purpose had been to prevent "needless competition and *to regulate controlled monopolies* for the prevention of uneconomic waste."[214] Noting the circumstances under which the rule had been applied to other public utilities in the state, the court concluded that the rule should not be inflexibly applied because its rationale was grounded in the "prevention of wasteful duplication in public service enterprises, and *the avoidance of uneconomic and unnecessarily [sic] duplicating facilities.*"[215] "The ultimate objective of the rule is the public convenience and benefit from efficient and adequate utility service."[216]

This is regulated competition language. What prompted the court to modify the *Tri-State Transit* rule by shifting emphasis from the utility's right to be free from competition within its certificated area to public convenience and benefit? To justify its holding, the court relied on the commission's finding that there were technological differences between the two types of radiotelephone services. Thus certification would not result in the type of duplication which the *Tri-State Transit* rule forbade.[217] This is essentially a recognition by the court that competition is not only sometimes desirable for public convenience within a

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[210] See note 91 and accompanying text *supra*.

[211] 251 Miss. 106, 168 So. 2d 728 (1964).

[212] *Id.* at 112, 168 So. 2d at 728.

[213] *Id.* at 119, 168 So. 2d at 733.

[214] *Id.* at 117, 168 So. 2d at 732 (emphasis added). Although the court here spoke of regulated "controlled monopolies," this is not the determining factor in deciding whether principles of regulated competition or regulated monopoly are being applied. Rather, it is the *basis* of the decision, such as a finding that duplication is economical, that reveals the controlling rationale.

[215] *Id.* at 119, 168 So. 2d at 732 (emphasis added).

[216] *Id.* at 120, 168 So. 2d at 733.

[217] *Id.* at 121-22, 168 So. 2d at 733-34.

particular utility industry, but also that technological advances and changes within that industry often make competition desirable, especially where there is an adequate market. The *Keith* case, therefore, provided an excellent basis for the court's decision in *South Mississippi.*

Despite the foundation laid in *Keith*, the *South Mississippi* court needed further justification for avoiding the *Tri-State Transit* rule as applied in *Elton.* It attempted to get around the rule by stating:

> A comparison of Tri-State with the case at bar produces a strained analogy at best. It dealt with the right of two common carriers . . . to offer passenger service to the public over the same route or highway. The commission found that a certificate of public convenience and necessity was not warranted by the facts before it. . . . Though the "existing facility" rule was announced in the opinion, *the case actually turned upon the basis of there being substantial evidence to support the finding of the commission.* Here the issues are not directly related to the public. Neither are they related to the same service area, but rather the issues presented here relate to the contested right of two corporate utilities to serve with wholesale electricity a facility (delivering point) or link between or adjacent to two service areas. However, assuming but not deciding, that there is a close analogy between the two cases, we still are of the opinion that this assignment of error is not well taken. *We rely upon the commission's specific finding that there was no uneconomic duplication here and in so doing we follow precisely the Court's ruling in Tri-State as it too relied specifically upon the finding of the commission as the basis for its decision.*[218]

Therefore, the "substantial evidence" rule, or so the court indicated, justified the inapplicability of *Tri-State Transit.* The rule, simply stated, is that if there is substantial evidence to support an order of the commission, then such order will not be reversed by a reviewing court.[219]

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[218] 254 Miss. at 771-72, 183 So. 2d at 169, *cert. denied*, 385 U.S. 823 (1966) (emphasis added).

[219] MISS. CODE ANN. § 77-3-67(4)(1972).

> The commission's order shall not be vacated or set aside either in whole or in part, except for errors of law, unless the court finds that the order of the commission is not supported by substantial evidence, is contrary to the manifest weight of the evidence, is in excess of the statutory authority or jurisdiction of the commission, or violates constitutional rights.

See Keith v. Bay Springs Tel. Co., 251 Miss. 106, 114-15, 168 So. 2d 728, 730 (1964); Mississippi Power Co. v. East Miss. Elec. Power Ass'n, 249 Miss. 869, 872, 164 So. 2d 479, 480 (1964); Dixie Greyhound Lines v. Mississippi Pub. Serv. Comm'n, 190 Miss. 704, 715, 200 So. 579, 581 (1941).

It is not easy to define substantial evidence or recognize it when a court finds that it exists. In Central Elec. Power Ass'n v. Hicks, 236 Miss. 378, 110 So. 2d 351 (1959), the Mississippi Supreme Court adopted the United States Supreme Court's definition in Consolidated Edison Co. v. NLRB, 305 U.S. 197, 229 (1938):

No doubt, the substantial evidence rule was the only route the court could take to relieve itself of its dilemma without actually having to explain *Tri-State Transit* away. This rule has been the court's "catch-22" when it has needed to justify a difficult decision involving competing utilities. For example, when the commission in the *Elton* case determined that public convenience and necessity would be served by MP&L supplying electricity to the industrial plant, the court justified its reversal of the commission by holding that the evidence was not sufficient to warrant the granting of such a certificate in an area where the certificated cooperative had a right to serve.[220] Yet in *Keith v. Bay Springs Telephone Co.*,[221] the court justified its affirmance of the commission's decision to allow overlapping of certificated areas because substantial evidence supported the commission's order.[222] In essence, what the court did in those two decisions was to establish inconsistent rules of law and then scrutinize the record to see if the commission's findings substantiated each rule. In the same vein, the rule of law handed down in *Tri-State Transit,* that there absolutely should be no duplication of "utilities," is contrary to the rule of law in *South Mississippi*; that duplication is allowable where it is not wasteful; yet the court in the latter decision stated that it "followed" the ruling in *Tri-State Transit* on the basis that in both cases there was substantial evidence to affirm the commission.[223]

The failure of the court in *South Mississippi* to convincingly reconcile its decision with *Tri-State Transit* is again illustrative of the fact that courts and commissions are often not equipped to effectively deal with many of the technical and extraordinary facets of utility regulation.[224] Undoubtedly, however, the decisions of the Mississippi Public

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> Substantial evidence is more than a scintilla. It "means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." Substantial evidence "means evidence which is substantial, that is, affording a substantial basis of fact from which the fact in issue can be reasonably inferred . . . ."

236 Miss. at 389, 110 So. 2d at 357.

In a more recent case the court has pointed out that in reviewing a record of an administrative agency (*e.g.*, Workmen's Compensation Commission) to determine whether there is substantial evidence to support the agency's order, the court will examine all the evidence. Harpole Bros. Constr. Co. v. Parker, 253 So. 2d 820 (Miss. 1971). Although not stated, the court appears to have based its decision in Mississippi Power Co. v. Mississippi Pub. Serv. Comm'n, 291 So. 2d 541 (Miss. 1974), upon a preponderance of the evidence. The practical effect of these two cases may be to dilute the substantial evidence rule and to substitute a more thorough examination of administrative agency orders to determine where a preponderance of the evidence lies.

[220] 240 Miss. 139, 153, 125 So. 2d 739, 744 (1961).

[221] 251 Miss. 106, 168 So. 2d 728 (1964).

[222] *Id.* at 114, 168 So. 2d at 730.

[223] 254 Miss. at 771-72, 183 So. 2d at 169, *cert. denied,* 385 U.S. 823 (1966).

[224] *See* Lovejoy, *supra* note 30, at 306.

Service Commission and Mississippi Supreme Court are, in sum, good faith efforts to reconcile the opposing interests among utilities themselves and the public.[225] Yet, though these decisions resolved immediate conflicts, they have hindered the formulation of a uniform regulatory policy which is essential to effective state regulation of public utilities.

B. Competition Between Municipal Franchisees and Other Regulated Utilities

The expansion of municipalities into areas already served by certificated utilities presents a different setting for the application of principles of regulated monopoly or regulated competition. The principal question is whether a regulated electric utility serving a municipality pursuant to a franchise has the right to extend its facilities and services into areas annexed by the city.

Urbanization in America brought about the need to provide electricity on a monopoly basis.[226] The characterization of the electric utility industry as a "natural monopoly" in its early stages of development was largely due to urbanization.[227] Since the operation of electric utilities required the use of public roads, most states allowed municipalities to control the utilities through the granting of municipal franchises.[228]

A municipal franchise, however, differs from a state franchise in that

> [t]he local franchises, while having elements of property, confer no contractual or property right to be free of competition either from individuals, other public utility corporations, or the state or municipality granting the franchise.[229]

Moreover, it was rather early established in Mississippi that a municipality may not grant an exclusive franchise to an electric utility.[230]

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[225] *See* Smyser, *supra* note 45, at 37.

[226] *See* Lovejoy, *supra* note 30, at 300.

[227] *See* W. JONES, *supra* note 184, at 27.

[228] *Id.; see, e.g.*, ALASKA STAT. § 29.48.050 (1972); ARK. STAT. ANN. § 73-208 (1947); CAL. PUB. UTIL. CODE § 6202 (West Supp. 1975); ILL. ANN. STAT. ch. 111 2/3, § 85 (Smith-Hurd 1966); KY. CONST. § 164; KY. REV. STAT. ANN. § 278.020(3) (1962); PA. STAT. tit. 66, § 1351 (1959); S.D. COMPILED LAWS ANN. §§ 9-35-1, -3, (Interim Supp. 1975); WASH. REV. CODE ANN. §§ 80.32.010, -.040 (1962); WIS. STAT. ANN. § 196.51 (1957); WYO. CONST. art. 13, § 4; WYO. STAT. ANN. § 15.1-13 (Supp. 1975). *See also* M. GLAESER, *supra* note 13, at 71-72.

[229] Tennessee Elec. Power Co. v. TVA, 306 U.S. 118, 139 (1939); see Mississippi Power Co. v. City of Aberdeen, 95 F.2d 990 (5th Cir. 1938); Iowa Elec. Light & Power Co. v. Marshall County Rural Elec. Cooperative, 6 P.U.R.4th 294 (Iowa Commerce Comm'n 1974); Mississippi Power & Light Co. v. Town of Coldwater, 234 Miss. 615, 638, 106 So. 2d 375, 381-82 (1958). *But see* Decatur County Rural Elec. Membership Corp. v. Public Serv. Comm'n, 261 Ind. 128, 301 N.E.2d 191 (1973).

[230] Mississippi Power Co. v. City of Aberdeen, 95 F.2d 990, 992 (5th Cir. 1938).

In Mississippi, public utilities operating within municipalities are subject to regulation by the public service commission. As a condition precedent to the granting of a certificate of public convenience and necessity to operate within a city, however, the utility must be awarded a franchise by the city.[231] Since a municipal franchise does not confer any right to be free from competition within a city, the certificate of public convenience and necessity must be examined to see if it grants such a right. As shall be seen, the certificate grants a greater degree of protection both to the franchisee and to any other electric utility operating near the city's boundaries than was seen in the cases involving disputes between electric utilities operating outside municipal boundaries.

In *Delta Electric Power Association v. Mississippi Power & Light Co., Inc.*,[232] (*Winona*), MP&L had been providing the city of Winona with electricity under a municipal franchise.[233] Delta Electric, a rural cooperative, had been serving an area west of the city for 19 years prior to the litigiation.[234] After passage of the 1956 Act, Delta Electric was granted a grandfather certificate for this area. In late 1959, Winona annexed part of Delta Electric's certificated area.[235] When MP&L built facilities for service into the annexed area, Delta petitioned the public service commission for a cease and desist order and to require MP&L to remove its lines from Delta's certificated area.[236] MP&L answered, alleging that its franchise from the city expanded with expansion of city limits.[237] The Mississippi Municipal Association was allowed to intervene in favor of MP&L.[238]

The commission held for Delta Electric since it had been rendering adequate service within the area,[239] but this ruling was reversed by the Chancellor for the First Judicial District of Hinds County, who held that upon expansion of the city limits, MP&L's franchise superseded Delta's certificate.[240]

The Mississippi Supreme Court reversed the chancellor and rein-

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[231] MISS. CODE ANN. § 77-3-19 (1972). As a general rule, however, the commission has no such authority over municipal electric utilities. *Id.* § 77-3-1 (1972); *see* 39 MO. L. REV. 658, 661 (1974).

[232] 250 Miss. 482, 149 So. 2d 504, *appeal dismissed and cert. denied,* 375 U.S. 77 (1963).

[233] *Id.* at 496-97, 149 So. 2d at 506.

[234] *Id.* at 497, 149 So. 2d at 507.

[235] *Id.* at 498, 149 So. 2d at 507.

[236] *Id.*

[237] *Id.*

[238] *Id.* at 495, 149 So. 2d at 506.

[239] *Id.* at 499, 149 So. 2d at 507-08.

[240] *Id.* at 495, 149 So. 2d at 506.

stated the commission's order.[241] The court addressed the issue of whether, under the 1956 Act, municipal expansion invalidated a prior grandfather certificate thereby allowing a franchisee to provide electricity to an annexed area previously served by another utility.[242] In answering in the negative, the court reviewed prior decisions made under section 5 of the 1956 Act to conclude that

> certificates to public utilities are based on an area basis, are valuable rights, although nonexclusive, entitled to protection of the courts, and the Commission . . . has "exclusive original jurisdiction over the intrastate business and property of public utilities."[243]

The court further stated that the 1956 Act would not permit annexation of an area to supersede the right of a certificated utility to serve that area, and that section 5 of the Act permitted operation of two utilities within a single municipality.[244]

Although an earlier decision intimated that one utility might be allowed to invade another utility's franchised area within a municipality,[245] the court held that when a utility holds a certificate within a municipality where it operates as a franchisee, it is entitled to extend its facilities in that area without fear of invasion from another utility.[246] However, when the city in which it operates expands and takes in another utility's certificated area, the franchise does not take preference over the annexed certificated area.[247] In this regard, the court noted that the only situation in which a certificate can be cancelled is when a utility is not rendering adequate service and "fails to do so after ordered to correct [the situation]."[248]

MP&L's argument, which would have made expansion of city limits an additional ground for cancelling a certificate, was considered inconsistent with the Act.[249] Moreover, automatic expansion of the franchise would be inconsistent with the legislature's "purpose to avoid duplicating facilities."[250] The court concluded by noting that after annexation of Delta Electric's territory, the city could reasonably regulate "the manner in which Delta's lines . . . are maintained," subject to the

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[241] *Id.*

[242] *Id.*

[243] *Id.* at 502-03, 149 So. 2d at 509.

[244] *Id.* at 503-04, 149 So. 2d at 510.

[245] Mississippi Power & Light Co. v. Town of Coldwater, 234 Miss. 615, 634, 106 So. 2d 375, 382 (1958).

[246] 250 Miss. at 505, 149 So. 2d at 510-11.

[247] *Id.* at 506, 149 So. 2d at 511.

[248] *Id.* at 507, 149 So. 2d at 511.

[249] *Id.*

[250] *Id.* at 509, 149 So. 2d at 512.

commission's primary jurisdiction over services.[251]

The court's decision in the *Winona* case squares with the general rule in Mississippi favoring regulated monopoly in the electric utility industry. Such protection of the annexed area's territorial integrity, however, appears to place Mississippi in the minority; other states have not given the annexed area as much freedom from duplicative competition.[252] This is further evidence that Mississippi's certificate of public convenience and necessity gives its holders a high degree of protection.

Interestingly, the *Winona* court did not mention the *Tri-State Transit* rule, though it did refer to the Mississippi Motor Carrier Act.[253] The court relied upon the *Elton* case, which represents the adoption of the regulated monopoly concept for regulation of Mississippi's electric utilities. *Winona*, however, offers much stronger support for the argument that Mississippi adheres to the regulated monopoly theory because it displays the degree to which the court will go to protect a certificated electric utility from competition within its service area.[254]

The extent to which the court will protect a certificated utility reaches its illogical conclusion in *Capital Electric Power Association v. Mississippi Power & Light Co.*,[255] *(Mississippi College)*, wherein the court wearily prefaced its decision: "This is another foray of a combat which apparently like Tennyson's Brook goes 'on forever' between two implacable utility behemoths."[256]

In 1924, MP&L began serving the city of Clinton under a franchise which was subsequently renewed in 1946. MP&L entered into a separate contract with Mississippi College, located in Clinton, to provide electrical service.[257] In 1961, the city limits were extended to include a part of the campus which contained a newly constructed dormitory.[258] MP&L

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[251] *Id.* at 511, 149 So. 2d at 513.

[252] *See, e.g.*, Georgia Power Co. v. Altamaha Elec. Membership Corp., 221 Ga. 521, 145 S.E.2d 691 (1965); Morgan County Rural Elec. Membership Corp. v. Public Serv. Co., 253 Ind. 541, 255 N.E.2d 822 (1970); Kentucky Util. Co. v. Farmers Rural Elec. Cooperative, 362 S.W.2d 498 (Ky. 1962); Missouri Pub. Serv. Co. v. Platte-Clay Elec. Cooperative, 407 S.W.2d 883 (Mo. 1966); Franklin Power & Light Co. v. Middle Tenn. Elec. Membership Corp., 222 Tenn. 196, 434 S.W. 2d 829 (1968).

[253] 250 Miss. at 502, 149 So. 2d at 509 (defining a statutory public utility).

[254] Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 250 Miss. 514, 150 So. 2d 534, *cert. denied*, 375 U.S. 77 (1963), is the companion case to the *Winona* decision. Since it presents a factual situation identical to that in the *Winona* case and the court reached the same result, it will not be discussed.

[255] 218 So. 2d 707 (Miss. 1969).

[256] *Id.* at 709.

[257] *Id.* at 710-11.

[258] *Id.* at 710. For a conflict between the same parties resulting from this annexation, see Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 250 Miss. 514, 150 So. 2d 534, *cert. denied*, 375 U.S. 77 (1963).

had received a certificate for its service in Clinton before the annexation.

Capital Electric had received a grandfather certificate for areas continguous to Clinton, and the land on which the newly constructed dormitory was situated was certificated to Capital Electric.[259] When the city annexed this area, MP&L built a distribution system into the area where the dormitory was being constructed. When this system was converted for permanent service for the completed dormitory, Capital Electric filed a cease and desist order with the commission, which was granted in 1961.[260] MP&L's original position was that its franchise with the city expanded with the city annexation and that it had grandfather rights with its single customer, Mississippi College.[261] That position changed, however, after the *Winona* decision. Obviously proposing to deliver electricity to a point located within its own certificated area and then allow the college to distribute the energy from that point to the dormitory,[262] MP&L sold the distribution system to Mississippi College. In 1965, the commission rendered a final cease and desist order which was overruled by the chancellor who found that the college had the right to serve itself within Capital Electric's certificated service area.[263]

On appeal, the Mississippi Supreme Court reversed the chancellor and reinstated the commission's order. The court once again stressed Mississippi's policy of "territorial integrity" of service areas and the notion that duplication of services and facilities is per se wasteful.[264] Although there was no duplication of facilities actually owned by MP&L, the court indicated that the "place of delivery of the electric current does not control, but rather the place and purpose of that energy," and that to allow MP&L to service the dormitory would be to permit it to "take property" of Capital Electric without due process of law.[265]

> The controlling factor herein is that the electricity is *used* within Capital Electric's certificated area to provide electrical energy to a building completely within that service area. The fact that the current is metered in [MP&L's] service area does not negate this result. . . . Also, the fact that Mississippi College, the consumer, is not a "public utility" within the meaning of the Act does not affect the authority of the Commission to issue a cease and desist order against [MP&L] which is unarguably a "public utility" under the Act.[266]

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[259] 218 So. 2d at 711.
[260] *Id.* at 710.
[261] *Id.*
[262] *Id.* at 711.
[263] *Id.* at 711-12.
[264] *Id.* at 713.
[265] *Id.*
[266] *Id.* at 714 (emphasis added).

The court added:

> The explicit policy under our Act has been one of *"exclusive"* service area. If [MP&L] cannot serve [the dormitory] directly, certainly to do so indirectly would be a violation of the Act. Any right to serve [the dormitory] must come from rights statutorily possessed by [MP&L].[267]

These statements by the court are conclusive of the regulated monopoly concept. Yet they are not easily reconciled with the holding in *South Mississippi*; that duplication of services and facilities should be prevented *only* when it would be wasteful.[268] Surely it would have been difficult for Capital Electric in *Mississippi College* to prove that MP&L's lines, which extended solely to the dormitory, would be wasteful. The court, however, refused to allow "frozen lines" to the dormitory on the grounds, borrowing a phrase from *Elton,*[269] that such "could lead to endless duplication of facilities and make a complete sham of the Act."[270]

As in *Winona,* the court in *Mississippi College* did not mention the *Tri-State Transit* rule. Rather, the court placed greater reliance upon *Elton* and *Winona.*[271] In neither of these cases, however, was the *Tri-State Transit* rule actually needed, for by the time the court decided *Mississippi College* in 1969, it was apparent that the court was convinced, somewhat erroneously in light of *Keith*[272] and *South Mississippi,*[273] that Mississippi regulatory policy favored the exclusivity and "territorial integrity" of the certificated service area. It appears, therefore, that the court has been even more willing to protect the certificated area in factual situations involving competition between regulated utilities operating under municipal franchises and regulated utilities bordering the franchised areas.

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[267] *Id.* (emphasis added).

[268] Mississippi Power Co. v. South Miss. Elec. Power Ass'n, 254 Miss. 754, 763, 183 So. 2d 163, 168, *cert. denied,* 385 U.S. 823 (1966).

[269] Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 153, 125 So. 2d 739, 744 (1961).

[270] 218 So. 2d at 715. Nevertheless, the court did recognize circumstances where one company's facilities were allowed to become frozen in another utility's certificated area. *Id.; see* East Miss. Elec. Power Ass'n v. City of Louisville, 250 Miss. 777, 168 So. 2d 287 (1964).

[271] The same is true for the only other decision in this category. *See* Mississippi Power & Light Co. v. Capital Elec. Power Ass'n, 222 So. 2d 399 (Miss. 1969)(involving the same issues and results).

[272] 251 Miss. 106, 168 So. 2d 728 (1964).

[273] 254 Miss. 754, 183 So. 2d 163, *cert. denied,* 385 U.S. 823 (1966).

C. *Appraisal of Mississippi Regulatory Policy*

A review of Mississippi cases dealing with conflicts between electric utilities, both private and rural cooperative, reveals behavior patterns peculiar to the electric utility industry. For example, it has been noted that competition between private companies along the boundaries of service areas is usually rare.[274] This appears to be the case in Mississippi since no such conflicts have reached the state supreme court. On the other hand, behavior patterns change markedly in regulated monopoly states where governmemt competition in the form of rural cooperatives has been introduced near areas certificated to private companies.[275] *South Mississippi*[276] seems to bear this out, for as was noted in the discussion of that case, the court altered its previous reasoning to justify duplication of facilities within a particular service area.[277]

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[274] Meeks, *supra* note 46, at 94.

[275] *See* R. HELLMAN, *supra* note 104, at 30.

[276] Mississippi Power Co. v. South Miss. Elec. Power Ass'n, 254 Miss. 754, 183 So. 2d 163, *cert. denied,* 385 U.S. 823 (1966).

[277] See notes 203 through 209 and accompanying text *supra.* For an in-depth examination of conflicts between private utilities and rural cooperatives see R. HELLMAN, *supra* note 104, at 189-227. *See also* Comment, Alabama Power Company v. Alabama Electric Cooperative: *Rural Electrification and the Antitrust Laws—Irresistible Force Meets Immovable Object,* 55 VA. L. REV. 325 (1969).

A question arises as to the categorization of rural cooperatives as "government" competition in the electric utility industry. Rural cooperatives were created by the Rural Electrification Act, 7 U.S.C. §§ 901 *et seq.* (1970), which authorizes federal government loans for the purpose of creating and maintaining rural electrification. *See* Mississippi Rural Electrification Authority Law, MISS. CODE ANN. §§ 77-5-1 *et seq.* (1972). Although it has been held that rural cooperatives are instrumentalities of the United States, Alabama Power Co. v. Alabama Elec. Cooperative, Inc., 394 F.2d 672, (5th Cir.), *cert. denied,* 393 U.S. 488 (1968), they are, nevertheless, private in nature. R. HELLMAN, *supra* note 104, at 152, 191; *cf.* NLRB v. Natchez Trace Elec. Power Ass'n, 476 F.2d 1042 (5th Cir. 1973)(Mississippi electric cooperative not a state political subdivision). For the purposes of this article they are treated as private in character.

One writer has stated that the purpose of the REA has changed since its inception from an agency to help bring electricity to the nation's rural areas to a "government-subsidized system competing directly with private suppliers for newly urbanized markets." Comment, *supra,* at 359. However, congressional intent in passing the Rural Electrification Act was not to provide public competition for the private companies. 80 CONG. REC. 5283 (1936)(remarks of Representative Rayburn); *cf. id.* at 2751 (remarks of Senator Norris); Comment, *supra,* at 328. But when private companies have challenged REA competition the courts have either held that the companies lacked standing or that the Administration's decisions could not be reviewed. *E.g.,* REA v. Northern States Power Co., 373 F.2d 686 (8th Cir.), *cert. denied,* 387 U.S. 945 (1967); REA v. Central La. Elec. Co., 354 F.2d 859 (5th Cir.), *cert. denied,* 385 U.S. 815 (1966); Kansas City Power & Light Co. v. McKay, 225 F.2d 924 (D.C. Cir.), *cert. denied,* 350 U.S. 884 (1955); Missouri Power & Light Co. v. Lewis County Rural Elec. Cooperative Ass'n, 235 Mo. App. 1056, 149 S.W.2d 881 (1941); *see* Comment, *supra,* at 332. The same rationale has been used to deny antitrust relief to private companies. *Id.*

Mississippi regulatory policy regarding the electric utility industry, therefore, is decidedly that of regulated monopoly, the only aberration being *South Mississippi*[278] which involved wholesale sales of electricity. The embodiment of this policy is in the *Tri-State Transit* "existing facility" rationale,[279] which basically provides that a

> certificate should not be granted where there is existing adequate service . . . and, if inadequate, unless the existing [utility] has been

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The question, therefore, becomes one of territorial protection for the cooperatives. Generally, if the cooperative falls within a state's definition of a "public utility," it will be afforded this territorial protection. The Mississippi Supreme Court has held that a rural cooperative is a public utility within the 1956 Act, Mississippi Power Co. v. East Miss. Elec. Power Ass'n, 244 Miss. 40, 49, 140 So. 2d 286, 288 (1962), and has, therefore, afforded substantial protection for cooperatives in certificated service areas. Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 125 So. 2d 739 (1961); *cf.* MISS. CODE ANN. §§ 77-3-5, -11 (1972). For states authorizing the granting of certificates of public convenience and necessity for service areas to cooperatives see, *e.g.*, ARK. STAT. ANN. § 73-202.1 (Supp. 1975); COLO. REV. STAT. ANN. § 115-1-3 (1963); KY. REV. STAT. ANN. § 278.020 (1969). *See also* Tucson Gas, Elec. & Light Co. v. Trico Elec. Cooperative, 2 Ariz. App. 105, 406 P.2d 740 (1965); Dairyland Power Cooperative v. Brennan, 248 Minn. 556, 82 N.W.2d 56 (1957). For a contrary view regarding protection for cooperative service areas see Farmers Elec. Cooperative v. Arkansas Power & Light Co., 220 Ark. 652, 249 S.W.2d 837 (1952); Louisiana Power & Light Co. v. Louisiana Pub. Serv. Comm'n, 250 La. 595, 197 So. 2d 638 (1967).

A more recent controversy involves the annexation of cooperative service areas by municipalities receiving "central station service," such as would be provided by a private company or a municipal electric utility. The Rural Electrification Act specifically provides that no loan should be made for service in areas which are receiving "central station service." 7 U.S.C. § 904 (1970). This limitation is itself an indication that Congress did not intend public competition with private companies. Comment, *supra*, at 336. Several states have accordingly held that a cooperative may not compete with a private company in an area which is receiving "central station service." *E.g.*, Public Serv. Co. v. Public Util. Comm'n, 142 Colo. 135, 350 P.2d 543 (1960); Montana-Dakota Util. Co. v. Divide County School Dist. No. 1, 193 N.W.2d 723 (N.D. 1971); *cf.* Missouri Power & Light Co. v. Lewis County Rural Elec. Cooperative Ass'n, 235 Mo. App. 1056, 149 S.W.2d 881 (1941); Upshur-Rural Elec. Cooperative Corp. v. Texas, 381 S.W.2d 418, 422-23 (Tex. Civ. App. 1964).

One author has noted that this push by cities into rural areas threatens the very existence of rural cooperatives causing some cooperatives to be bought by private companies. R. HELLMAN, *supra* at 217-18; *see* McNair v. Capital Elec. Power Ass'n, 324 So. 2d 234 (Miss. 1975). However, this danger is not grave in Mississippi for, at least as of 1970, this state was 56 percent "rural." R. HELLMAN, *supra* at 148 (table). It is noteworthy that where the Mississippi Supreme Court has dealt with encroachment by private companies, the court has held almost exclusively in favor of the cooperatives, especially where municipalities have pushed into rural areas being serviced by cooperatives.

[278] Mississippi Power Co. v. South Miss. Elec. Power Ass'n, 254 Miss. 754, 183 So. 2d 163, *cert. denied*, 385 U.S. 823 (1966).

[279] *See* Mississippi Power Co. v. South Miss. Elec. Power Ass'n, 254 Miss. 754, 768-69, 183 So. 2d 163, 167-68, *cert. denied*, 385 U.S. 823 (1966).

> given an opportunity to furnish such additional service as may be required.[280]

As discussed previously, the *Tri-State Transit* rule was promulgated in a common carrier case, and was subsequently applied to the electric utility industry.[281] An appraisal of Mississippi regulatory policy in the electric utility industry must, therefore, begin with the *Tri-State Transit* rule. Two questions are posed: First, what is the status of *Tri-State Transit* in the common carrier industry today? Second, should a rule regulating common carriers be applied to electric utilities?

1. *Tri-State Transit* Today

More recent decisions by the Mississippi Supreme Court show a shift in regulatory policy for common carriers since *Tri-State Transit* was decided in 1944. *Tri-State Transit* stands for the regulated monopoly concept—duplication of services is per se wasteful competition. However, modern Mississippi common carrier cases reveal a transition to the regulated competition concept, which is based on the notion that duplication is permissible where business in an area will support it. For example, in *Garrett v. Delta Motor Line,*[282] the court stated:

> Permission may be granted an applicant to traverse a highway already being traveled by an existing carrier where such new travel is necessary to properly serve the new territory *and render such new service financially feasible.*[283]

Relying on the *Garrett* case, one noted public utilities authority has placed Mississippi in the category of states following the regulated competition concept in the common carrier industry.[284]

Tri-State Transit has been limited so as to apply only "where the transportation certificate of public convenience and necessity extends over a *given* route."[285] In *Louisiana Midland Transport Co. v. Hearin-Miller Transporters, Inc.,*[286] the court stated in dicta:

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[280] Tri-State Transit Co. v. Dixie Greyhound Lines, Inc., 197 Miss. 37, 48, 19 So. 2d 441, 444 (1944).

[281] *See* Capital Elec. Power Ass'n v. Mississippi Power & Light Co., 240 Miss. 139, 125 So. 2d 739 (1961).

[282] 224 Miss. 559, 81 So. 2d 245 (1955).

[283] *Id.* at 566, 81 So. 2d at 247 (emphasis added).

[284] A. PRIEST, *supra* note 52, at 366-67 & n.78.

[285] Barnett v. Movers Conference of Miss., Inc., 203 So. 2d 584, 586 (Miss. 1967) (emphasis added); *see* Morgan Drive-A-Way v. Lee, 243 Miss. 891, 897, 139 So. 2d 863, 864 (1962).

[286] 239 So. 2d 813 (Miss. 1970).

> It is apparent that an administrative agency (Mississippi Public Service Commission) is cautioned by the Legislature not to grant monopolies under the guise of public necessity and convenience. On the other hand, the Commission must guard against "unfair or destructive competitive practices". . . .[287]

The court also stated that public policy regarding operations of common carriers is to foster "sound economic conditions" rather than monopoly.[288]

Another case even more convincingly demonstrates that Mississippi now adheres to the regulated competition concept for common carriers. In *Barnett v. Movers Conference of Mississippi, Inc.*,[289] the Commission granted Barnett a certificate to transport household goods in an area already being served by Movers under a certificate. Barnett introduced evidence showing the rapid growth rate of industry, employment, homebuilding, population, and economic expansion in the proposed area. Movers, which protested Barnett's application, appealed from a decision upholding the commission. On appeal, Movers relied on *Tri-State Transit,* alleging that it was entitled to have its service area protected from competition, and that to allow an additional certificate would violate its certificated rights. In distinguishing *Tri-State Transit,* the court stated that it was not the legislature's intent "to chop this state into areas" so as to create a monopoly for a few certificated common carriers.[290]

> We have reached the conclusion that the Mississippi Public Service Commission has ample authority to add additional certificated movers and haulers in areas where conditions have changed, so that the public may be better served in a growing progressive area where the communities are rapidly expanding . . . .[291]

Thus, under *Barnett,* the commission would be justified in authorizing additional carrier service in another carrier's certificated area if the invading carrier can prove that additional service is economically feasible. This further supports the contention that Mississippi's current regulatory policy for common carriers is regulated competition and that

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[287] *Id.* at 815. Louisiana Midland appealed from a commission order denying it a certificate of public convenience and necessity to transport bulk cement. The application was opposed by Hearin-Miller, who already had a certificate for the proposed service area. *Id.* at 814.

[288] *Id.* at 815.

[289] 203 So. 2d 584 (Miss. 1967).

[290] *Id.* at 586.

[291] *Id.* at 587. Interestingly, after having made this ruling, the court held that "substantial evidence" supported the commission's order. *Id.;* see note 219 and accompanying text *supra.*

Tri-State Transit is no longer valid as a general statement of the rule in this state. The author suggests that the Mississippi Supreme Court recognize the change and expressly abandon the *Tri-State Transit* rationale. Rather than continuing to apply *Tri-State Transit* to prohibit additional service over "given" routes, the court should allow the commission to study given service *areas* to determine whether the business volume in a particular area will support additional service. As the court stated in *Barnett:* "It would tax the Commission unduly to make a detailed study of every highway in Mississippi before granting a certificate to transport . . . over all the highways of Mississippi."[292]

2. Application of Common Carrier Rules to Electric Utility Regulation

The Mississippi Supreme Court has utilized rules of common carrier regulation to resolve conflicts arising from competition in the electric utility industry. This transposition constitutes the principal reason for the confusion and lack of uniformity of regulatory policy in the electric utility industry in Mississippi. The court's misconception of three fundamental considerations has greatly contributed to the existing irregularity. First, the court has failed to distinguish between regulation of business under the "public interest" concept as opposed to the "public utility concept." Second, the court has failed to appreciate the economic differences separating the common carrier industry from the electric utility industry. Third, because of these differences, the court should recognize that the common carrier industry is not a "public utility" in the strict sense of the term.

State regulation of business is grounded in its police power.[293] Regulated businesses became "public utilities" by state or congressional legislation, depending on the intrastate or interstate character of the business.[294] The monopolistic character of all public utilities is, therefore, partly created by government.[295] Our courts and state regulatory bodies have, however, failed to clearly distinguish the narrow "public utility" concept which is based on economic monopoly *plus* public interest from regulation based solely on principles of "public interest."[296]

That an industry is affected with a "public interest" does not impart "public utility" status, for under its police power the state may

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[292] 203 So. 2d at 586.

[293] Lovejoy, *supra* note 30, at 293.

[294] P. GARFIELD & W. LOVEJOY, *supra* note 13, at 11.

[295] Lovejoy, *supra* note 30, at 298.

[296] *Id.* at 309-10. For evidence of this confusion in early Supreme Court decisions regarding public utility regulation, see New State Ice Co. v. Liebman, 285 U.S. 262 (1932); Frost v. Corporation Comm'n, 278 U.S. 515 (1929); Williams v. Standard Oil Co., 278 U.S. 235 (1929); Tyson & Bro. v. Banton, 273 U.S. 418 (1927).

regulate both those industries which are economically monopolistic in nature, hence "public utilities," and those industries which are merely affected with a public interest.[297] In the latter situation, the state legislature creates a "monopoly" by restricting competition in the name of public necessity and interest. It is this category into which common carriers fall; they are granted monopolies to a limited extent not because they are "natural monopolies," but because of public necessity. In the regulation of such businesses affected with a public interest, factors other than the adequacy of existing service can be considered.[298]

Public utility status, on the other hand, is based upon economic tests such as necessity, monopoly, service, price discrimination, large capital investments, etc.[299] While a particular industry may be subject to state regulation based on various economic and other reasons, the basic criterion is whether "it is felt that private enterprise cannot be relied upon to provide adequate service at a reasonable price."[300] From this arises the "public necessity" concept, for while a business may not be a "public utility" in the strict sense the state may nevertheless find it necessary to restrict competition in that business due to a public need "'without which the public is inconvenienced to the extent of being handicapped.'"[301] Public necessity, which is determined from present living standards and technology,[302] may dictate the limitation of competition within an industry even though the industry is not a "public utility." Therein lies the basis for common carrier regulation.

The foregoing discussion demonstrates that a monopoly in a regulated industry may arise either solely by government creation or by economic power. The general failure to recognize this distinction has given rise to the fallacious assumption that the common carrier industry has public utility status.

Monopoly arising from economic power results from various factors. The more important of these factors are (1) economies of scale,[303] which

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[297] Lovejoy, *supra* note 30, at 296-97.

[298] *See* Florida-Texas Freight, Inc. v. United States, 373 F. Supp. 479, 486 (S.D. Fla. 1973), *aff'd mem.*, 416 U.S. 976 (1974); Yellow Forwarding Co. v. ICC, 369 F. Supp. 1040, 1046 (D. Kan. 1973); Alabama Pub. Serv. Comm'n v. Chem-Haulers, Inc., 293 Ala. 677, 309 So. 2d 453 (1975).

[299] *See* Lovejoy, *supra* note 30, at 297-306. The dissents of early Supreme Court decisions have built up a series of these economic tests which have become important in public utility regulation. *Id.* at 295 & nn. 7 through 11.

[300] C. PHILLIPS, *supra* note 66, at 44.

[301] General Communications Sys., Inc. v. State Corp. Comm'n, 216 Kan. 410, 532 P.2d 1341, 1348 (1975), *quoting* Central Kan. Power Co. v. State Corp. Comm'n, 206 Kan. 670, 482 P.2d 1, 7 (1971); *see* Smyser, *supra* note 45, at 29.

[302] Lovejoy, *supra* note 30, at 297.

[303] "Economies of scale" refers to the tendency of unit costs to decline with increases in output. *See* W. JONES, *supra* note 184, at 50-51; C. PHILLIPS, *supra* note 66, at 21.

provide the basis for the "natural monopoly" characterization for public utility status;[304] and (2) difficulty in entering the industry because of requirements for large capital investments, control of sources of supply, and fear of exploitation by those in the industry.[305] On the other hand, monopoly arising from government creation is based on totally different criteria. An industry may be granted a monopoly in order to serve the public necessity, which demands regulation, but the industry may not necessarily be a public utility.[306]

One of the major reasons for justifying natural monopoly status in the electric utility industry is the large capital investment required—a signpost of public utility status. Vicious price competition and unchecked duplication of services would, therefore, result in long-run deterioration of service and facility quality.[307] Motor carriers, however, do not fall within such a category because that industry does not require so large a capital investment.[308] The need for motor carrier regulation arises not because they are public utilities, but because of the overabundance of competition which reduces the quality of service and adversely affects the public. The motor carrier industry, then, is an example of "legislative" monopoly "sought for the purpose of restricting entry into the field"[309] in the name of the public interest.

The Mississippi Supreme Court has taken a rule regulating competition within the common carrier industry—which is not in the strict sense a "public utility"—and has applied that rule to the electric utility industry, which is in the strict sense a "public utility." While there *may* be a justification for maintaining a monopolistic structure in the electric utility industry, the traditional economics of regulation are not supportive of such a contention in the common carrier industry.[310] Therefore, wherein lies the justification for applying *Tri-State Transit* to Mississippi's electric utility industry? The author suggest that there is none. Because the electric utility industry is distinct from other

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[304] A natural monopoly results when, due to the structure of an industry, or political or social factors, competition is inadequate to prevent the concentration of economic wealth and power.

Comment, *supra* note 49, at 787 n.19; *see* P. GARFIELD & W. LOVEJOY, *supra* note 13, at 1; Lovejoy, *supra* note 30, at 299-300.

[305] Lovejoy, *supra* note 30, at 298.

[306] *Id.* at 302.

[307] E. CLEMENS, ECONOMICS AND PUBLIC UTILITIES 27 (1950); R. HELLMAN, *supra* note 104, at 51; C. PHILLIPS, *supra* note 66, at 22; Lovejoy, *supra* note 30, at 301.

[308] Lovejoy, *supra* note 30, at 299, 301.

[309] P. GARFIELD & W. LOVEJOY, *supra* note 13, at 12; *see* Lovejoy, *supra* note 30, at 299.

[310] It should be noted that the regulated competition concept, which has been employed by the Mississippi Supreme Court in recent motor carrier decisions, denies that a particular industry is a natural monopoly. *See* note 88 and accompanying text *supra*.

regulated industries[311] (*i.e.*, common carriers), there is no reason why the court should not adopt a separate regulatory policy—regulated competition or regulated monopoly—to apply to each industry so as to better resolve the problems peculiar to each.[312] Moreover, if the court continues to apply motor carrier rules to electric utility regulation, would it not now be compelled to apply rules of regulated competition?

3. The Failure of Courts and Commissions

Although principles of public utility regulation appear to be settled in this state, there is a confusion of legal and economic concepts relating to regulated industries in general. This enigma, however, is not peculiar to Mississippi.[313] Legislative failure to specify public utility characteristics has burdened the courts in many jurisdictions.[314] Equally important is the general inability of state regulatory commissions to proficiently regulate utilities, particularly electric utilities.[315] As one observer has commented, commissions have

> lost sight of economic objectives and assumed that the goal of regulation was to prevent competition. Such assumptions can only lead to the abuse of monopoly power to the detriment of the public.[316]

A public utility commission should have expertise, flexible regulatory rules, and continuity of regulatory policy to effectively regulate our public utilities.[317] Lack of a uniform regulatory policy causes frequent litigation and confusion.[318] Inflexible regulation, likewise, is inadequate

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[311] *See* City of Idanha v. Consumers Power, Inc., 8 Ore. App. 551, 495 P.2d 294, 300 (1972).

[312] *Compare* State v. Public Serv. Comm'n, 240 Mo. App. 603, 211 S.W.2d 547, 551 (1948), *with* Missouri Pub. Serv. Co. v. City of Trenton, 509 S.W.2d 770 (Mo. Ct. App. 1974).

[313] *See* Lovejoy, *supra* note 30, at 292, 306.

[314] *Id.* at 307.

[315] R. HELLMAN, *supra* note 104, at 43; Stigler & Friedland, *supra* note 104, at 11; Comment, *supra* note 49, at 794-95. *See also* Miller, *supra* note 104, at 671; Bray, *supra* note 104, at 1, col. 6, 26, col. 3.

One reason given for the lack of effective electric utility regulation which is particularly pertinent to this article is that

> the individual utility system is not possessed of any large amount of longrun monopoly power. It faces the competition of other energy sources in a large proportion of its products' uses, and it faces the competition of other utility systems . . . to which its users may move.

Stigler & Friedland, *supra* at 11.

[316] Comment, *supra* note 49, at 804. Moreover, courts generally prefer findings and holdings of agencies; often the opinions amount to no more than mere rubber stamp approvals. *See* 1965 WASH. U.L.Q. 195, 208.

[317] *See* C. PHILLIPS, *supra* note 66, at 90.

[318] *See* Old Pueblo Transit Co. v. Arizona Corp. Comm'n, 84 Ariz. 389, 329 P.2d 1108 (1958).

in a modern technology where economic conditions are rapidly changing.[319] Therefore, it is desirable that Mississippi adopt a uniform regulatory policy for the electric utility industry which is designed for flexible regulation in order to accommodate the changes in the economic substance of a public industry which are likely to result from evolving social and technological forces.[320] In the next section such a policy will be tendered.

IV. The Regulated Competition Concept and the Electric Utility Industry

The traditional view in the regulation of electric utilities is that state policy discourages duplication of services, as competition results in waste and poorer services at higher costs.[321] It has been seen that Mississippi's regulated monopoly policy in the electric utility industry reflects this view. Given the notion that regulated competition denies that certain utilities are by *necessity* monopolies in the "usual regulatory sense,"[322] should Mississippi adopt the regulated competition concept as a uniform policy for the electric utility industry?

A. Competition in the Electric Utility Industry

Governmental control of monopolies is manifested in three forms: (1) antitrust laws, *i.e.*, enforcement of competition; (2) actual acquisition of the monopoly by the government, such as municipal ownership of utilities; and (3) recognition of monopoly status by the government in return for government regulation, *i.e.*, "public utility" regulation.[323] The electric utility industry traditionally has been regulated under the second and third methods. However, the economic tests which characterize an industry as a monopoly, and hence, as a public utility, are likely to change due to evolving social and technological forces;[324] "[m]onopoly is a function of time, location, technology, government permit, economic power, or some combination of these powers."[325] Furthermore, "[t]he extension of monopoly power beyond what is econom-

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[319] *See* C. Phillips, *supra* note 66, at 87.

[320] *See* Lovejoy, *supra* note 30, at 314.

[321] *See* F. Welch, *supra* note 27, at 76.

[322] See note 88 and accompanying text *supra*.

[323] Lovejoy, *supra* note 30, at 292, 299; *see* W. Jones, *supra* note 184, at 53; *cf.* R. Hellman, *supra* note 104, at 38.

As to government ownership, the costs of operation are the same as in a private firm, and there is less incentive to be progressive than exists with private ownership. W. Jones, *supra* at 53.

[324] Lovejoy, *supra* note 30, at 314.

[325] *Id.* at 298.

ically necessary may provide the electric company with artificial advantages" when competing with other power sources.[326]

While competition among businesses is generally beneficial, unrestrained competition among businesses which require large investments and fixed assets may become ruinous when such competing businesses are specialized and have unused capacity.[327] It has been assumed that the positive effects of competition as a natural regulator are sufficiently replaced by state regulation.[328] As one authority noted: "Anticompetitive principles are permitted to prevail in the utility industry only because there have been established alternative regulatory controls."[329]

However valid this assumption was during the formative years of the electric utility industry, it is at least questionable today. In the early years of public utility regulation, it was presumed, rather simplistically, that an industry was either competitive or monopolistic.[330] Before state regulatory commissions were created, utilities were granted charters and franchises—almost at random—to operate in specified areas.[331] The competition encouraged in the early development of public utilities soon gave way to ruinous duplication of facilities and services, resulting in a period of consolidation and merger.[332] The failure of self-regulation by competition gave way to state regulatory commissions.[333] Therefore, sound regulation of the electric utility industry in this "developmental" stage *dictated* that the industry be treated as a natural monopoly.[334] This natural monopoly argument provided the historical, theoretical rationale for eliminating most retail competition in the electric utility industry.[335] However, "[m]odern technology has tended to blur the common distinction" between utilities and other unregulated industries.[336] Concern is now being expressed that regulation in the utility

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[326] Meeks, *supra* note 46, at 76-77.

[327] C. PHILLIPS, *supra* note 66, at 40.

[328] R. HELLMAN, *supra* note 104, at 9.

[329] F. WELCH, *supra* note 27, at 89.

[330] Comment, *supra* note 49, at 787.

[331] C. PHILLIPS, *supra* note 66, at 85.

[332] Comment, *supra* note 49, at 787.

[333] R. HELLMAN, *supra* note 104, at 9-11; Comment, *supra* note 49, at 787.

Administrative control of public utilities arose "when it became plain that the operation of market forces were [*sic*] inadequate to protect the public interests." Handler, *Regulation Versus Competition*, 44 U. CIN. L. REV. 191, 194 (1975).

[334] Kauper, *An Overview in Antitrust and Regulated Industries: A Collision Course?*, 43 A.B.A. ANTITRUST L.J. 295 (1974).

[335] NUCLEAR REGULATORY COMMISSION, COORDINATION, COMPETITION, AND REGULATION IN THE ELECTRIC UTILITY INDUSTRY 10 (1975). Regulation of the electric utility industry resulted from a failure of the "traditional market mechanism, particularly in local retail markets." *Id.* at 13.

[336] C. PHILLIPS, *supra* note 66, at 143. Because so many unregulated industries engage

industry has failed as a substitute for competition.[337]

> [B]ecause of its complex nature, the electric power industry tends to defy effective regulation. There is no realistic standard by which resource allocation, price, quality, or material progress can be judged. So many variables affect profits that it is virtually impossible for regulatory commissions to realistically fix rates.[338]

The goals of competition and regulation are the same;[339] therefore, it seems feasible that today's modern electric utility could operate in a competitive market.[340] Competition, however, would be beneficial only within a regulatory framework[341] such as would exist under the regulated competition concept. In this sense, regulation and competition become complementary, for "[w]hile the regulatory process plays a significant role, competition complements that role by encouraging electric utilities to be more progressive and more efficient."[342] Competition within the regulatory framework would emphasize performance, rather than economical structure, as a disciplinary function within the industry.[343]

Recent judicial[344] and state regulatory commission[345] decisions indi-

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in cut-throat competition, this should not be the distinguishing point between utilities and unregulated industries. *Id.* at 41.

[337] *See* R. HELLMAN, *supra* note 104, at 70, 91-92, 228. *See generally* Stigler & Friedland, *supra* note 104; Comment, *supra* note 49.

> In agreeing that electric power should be a governmentally regulated commodity we may . . . too easily accept the facile but fallacious assumption that a choice between agency and market-place regulation must and has been made, and that in view of that choice, competitive discipline has no role to play in regulating the conduct of the electric power industry.

Meeks, *supra* note 46, at 130. Note that this is basically a regulated competition argument.

[338] Comment, *supra* note 66, at 798.

[339] NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 10-11. *See also* Kestenbaum, *Antitrust and Regulated Industries: A Collision Course,* 43 A.B.A. ANTITRUST L.J. 349, 370 (1974).

[340] Comment, *supra* note 49, at 804. *See also* NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 11-12.

[341] NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 13.

[342] *Id.* at 26; *see id.* at 2, 11. *But cf.* Slater, *Antitrust and Government Action: A Formula For Narrowing* Parker v. Brown, 69 NW. U.L. REV. 71, 104-05 (1974). *See also* Handler, *supra* note 333, at 194.

[343] NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 4.

[344] *See, e.g.,* REA v. Central La. Elec. Co., 354 F.2d 859 (5th Cir. 1966)(electric utilities not constitutionally protected from competition by an REA-financed cooperative); Northfield Woods Water & Util. Co. v. Illinois Commerce Comm'n, 28 Ill. App. 3d 664, 329 N.E.2d 295 (1975)(commission can allow service by two companies in a certificated area); Southern Gas & Elec. Co. v. Indiana Statewide Rural Elec. Cooperative, 251 Ind. 459, 242 N.W.2d 361 (1968)(competition between utilities allowable only where in public interest); Gulf States Util. Co. v. Jefferson Davis Elec. Cooperative, 230 So. 2d 273 (La. Ct. App. 1969)(allowing competition); North Carolina *ex rel.* Util. Comm'n v. Lumbee River Elec. Membership Corp., 275 N.C. 250, 166 S.E.2d 663 (1969)(customer may

cate a trend favoring competition. This trend is logical since regulation under the monopoly concept is too inflexible for effective state regulation of the electric utility industry. Mississippi's own experience has proved this to be true, as the *Tri-State Transit* rule has been too rigid to be enforced as a uniform rule of regulatory policy.[346] One study attempted to demonstrate that the only successful regulation of public utilities occurs where private companies come into competitive interaction with government utilities.[347] The United States Supreme Court also early recognized that there is a need for competition in industries affected with a public interest.[348]

The major reason for the states' inability to effectively regulate under the regulated monopoly concept has been the traditional assumption that because electric utilities have operated as geographic monopolies at the retail level they are necessarily monopolistic at all their market[349] levels. Even though electric utilities' vertical integration is well understood[350] there has been a failure to recognize that there are different markets for different products in the industry.[351] Thus, while monopoly may be a necessity for markets at the retail level due to the economic waste of duplication,[352] it does not follow that it is necessary at all

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choose among competing electric utilities); Oklahoma Gas & Elec. Co. v. Oklahoma Elec. Cooperative, Inc., 517 P.2d 1127 (Okla. 1973) (competition between cooperative and private company permissible); *cf.* Washington Gas Light Co. v. Virginia Elec. & Power Co., 438 F.2d 248 (4th Cir. 1971)(competition at retail level); Kauper, *supra* note 334, at 295, 298.

[345] *See, e.g., Re* Hills Elec. Light Co., No. 1826, Order No. 2535 (Hawaii Pub. Util. Comm'n, Dec. 2, 1970)(competition between electric and gas utilities is in public interest); *Re* Clark, No. X-8428 (Me. Pub. Util. Comm'n, July 24, 1974); *Re* Utah Power & Light Co., 76 P.U.R.3d 1 (Utah Pub. Serv. Comm'n 1968); Virginia State Corp. Comm'n v. Appalachian Power Co., 83 P.U.R.3d 525 (Va. Corp. Comm'n 1970).

[346] *See* Mississippi Power Co. v. South Miss. Elec. Power Ass'n, 254 Miss. 754, 183 So. 2d 163, *cert. denied,* 385 U.S. 823 (1966).

[347] R. HELLMAN, *supra* note 104, at 70. Companies in contact with TVA have cut their rates and at the same time have been able to attract enough investment capital for continuous and substantial growth. *Id.* at 163-65. *See also id.* at 228.

[348] United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290, 333-34 (1887); *see* Northern Pac. Ry. v. United States, 356 U.S. 1, 4 (1958).

[349] Comment, *supra* note 49, at 803.

[350] Almost all electric utilities are vertically integrated; that is, performing functions at all levels of the industry. *Hearings on S. 607 Before the Subcomm. On Intergovernmental Relations of the Senate Comm. on Government Operations*, 91st Cong., 1st Sess., pt. 2, at 301 (1969) [hereinafter cited as 1969 *Hearings*]; Comment, *supra* note 49, at 789.

[351] Comment, *supra* note 49, at 803.

[352] *See Re* South Carolina Elec. & Gas Co., 96 P.U.R.3d 417 (S. C. Pub. Serv. Comm'n 1972). The retail market is described generally as "energy sales to ultimate, or final use customers," *i.e.*, the ordinary consumer. NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 14.

At the retail level, the electric utility industry is marked by geographical areas ser-

levels.[353] For example, there are at least four different kinds of products presently available in the electric utility industry[354] which are distributed at three distinct market levels: (1) the retail level;[355] (2) the wholesale level;[356] and (3) the transmission level.[357] These factors create realistic opportunities for competition in the electric utility industry.[358] The

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viced under certificates of public convenience and necessity. Smaller systems, such as smaller cooperatives and municipal systems which purchase their power from the larger, encompassing system, operate within that area as "islands." Meeks, *supra* note 46, at 68-69. Such geographic lines cause "rigidly confined geographical markets and limited flexibility in transferring capacity from one market to another." W. JONES, *supra* note 184, at 51-52.

[353] Meeks, *supra* note 46, at 76.

[354] These products are: (1) base-load power, which is the power a company must maintain at all times; (2) peaking power, which a company must maintain to allow the system to function during "peak" demand; (3) reserve power, which is the amount of capacity necessary to meet emergencies, equipment failure, etc.; and (4) economy power, which is bought from an outside source cheaper than if it had been internally produced. *See* Meeks, *supra* note 46, at 70-73.

[355] Competition for the location of large industrial users would be beneficial at the retail level. NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 17. Competition between companies with bordering service areas is beneficial and should be encouraged. Meeks, *supra* note 46, at 77. To the extent that electric utilities "promote the development of their respective service areas," they engage in retail competition. NUCLEAR REGULATORY COMMISSION, *supra* at 17.

[356] "Wholesale sales" of electricity refers to electricity delivered to another utility, which then resells the energy at the retail level to ultimate consumers. NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 17. The wholesale market allows a purchasing utility to choose from the lowest prices among competing companies. Comment, *supra* note 49, at 789. However, there is a reluctance among companies to offer wholesale power to purchasers in other service areas. NUCLEAR REGULATORY COMMISSION, *supra* at 19. The growth of interconnected electrical systems, called "pooling," as well as technological advances in the electric field, lead to a likelihood of beneficial wholesale competition. *See* NUCLEAR REGULATORY COMMISSION, *supra* at 18; Meeks, *supra* note 46, at 81, 105, 107, 109.

[357] Large transmission lines are necessary to transport high voltage over long distances and for interconnection of systems. *See* Meeks, *supra* note 46, at 74. Interconnections are transmission lines connecting utility systems. The use of interconnections has given rise to power pooling and has allowed utilities to use economy power to hold down rates during periods of peak demand. Comment, *supra* note 49, at 791 & nn.43-44. Also, smaller companies with less demand can interconnect to share capacity expenses and reserve power. *Id.* at 791-92. Large, vertically integrated companies which produce wholesale electricity control the transmission systems and pose a serious obstacle to competition at this level. Meeks, *supra* note 46, at 86-87. Duplication of large transmission systems, however, would undoubtedly be wasteful. *Id.* at 91, 94.

[358] There are other potential major areas for competition, particularly "yardstick" competition and competition among "bulk supply" plants. "Yardstick" competition has been described as "a process of performance comparison between and among various utilities within the industry. These comparisons attempt to measure the relative success of different operational or marketing approaches." NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 20 (footnote omitted). This is a valuable tool in evaluating the perform-

recent increase in concentration within the industry, including the emergence of integrated systems,[359] also enhances the prospects for creation of new markets in the industry.

There is a role for competition in the electric power industry. The regulated competition concept of public utility regulation can provide the functional framework for competition in the industry. As one recent study of the electric power industry concluded:

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ance of electric utilities competing within a particular geographical area. *See* Meeks, *supra* note 46, at 77-81.

"Bulk power supply" competition refers to a mixing of purchases of wholesale power, self-generation, and coordination arrangements. *See* NUCLEAR REGULATORY COMMISSION, *supra* at 23-24; Meeks, *supra* at 67.

Competitive opportunities in the electric power industry may be summarized in this fashion.

TABLE I

Opportunities for Competition in the Electric Utility Industry: A Summary

Opportunity		Description
1.	Retail Load Competition	Industrial location; borderline or fringe area loads; municipal annexation; franchise renewals.
2.	Wholesale Load Competition	Sales for resale through line extension or wheeling.
3.	Yardstick Competition or Comparative Analysis	Performance comparisons by regulators, managers, stockholders, and/or voters.
4.	Competition among the Components of Bulk Power Supply	Selection among alternative products/services in planning a bulk power supply system; also, among the alternative physical inputs used to produce these services.

Source: NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 27.

For a detailed study of markets for competition in the electric utility industry, see *id.* *See also* Meeks, *supra*; Comment, *supra* note 49.

[359] Meeks, *supra* note 46, at 65; 1969 *Hearings*, *supra* note 350, at 311.

There are almost 3,500 operating electrical systems in the United States. NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 1. Seventy percent of these systems are engaged in distributing power, although they purchase nearly all of their bulk power supply. *Id.* at 18. The federal government generates a large amount of power for its own use, but does not engage in retail sales. Meeks, *supra* note 46, at 69. In 1972, 77 percent of all electrical power was privately generated, 11 percent was generated by municipalities, and 12 percent was generated by the federal government. W. JONES, *supra* note 184, at 14. *See also* Meeks, *supra* at 68, 75. The 200 largest private electrical systems in the country control nearly 75 percent of all generating capacity. A large number of these systems are joined horizontally through holding companies, and account for nearly 40 percent of all generating capacity by private systems. NUCLEAR REGULATORY COMMISSION, *supra* at 32.

> Even though the electric utility industry requires regulation, the major goals of that regulation should be to encourage the desirable characteristics of [competition] and to promote opportunities for competitive processes to work.[360]

Regulated competition, therefore, could be implemented on the premise that where competition will neither work nor produce desirable consequences, then it is time for "forceful and rational regulatory action."[361]

B. Application of Antitrust Laws to the Electric Utility Industry

In 1970, the Council of Economic Advisors reported that "[t]he American experience with regulation, despite notable achievements, has had its disappointing aspects. Regulation has too often resulted in protection of the status quo."[362] The council noted that when faced with competition, industries have become more progressive.[363] Because regulatory agencies should determine competition's role in our regulated industries,[364] state legislatures should consider undertaking studies to determine "whether the goals of regulation have been achieved or whether, in the decades since the enactment of the pertinent regulatory statute, such goals have lost any of their relevance."[365] The legislatures should include in their studies an examination of the impact of antitrust laws[366] on electric utility regulation with a view toward determining whether regulation can be replaced by competition.[367] Failure to take this important step could result in the imposition of federal antitrust policies upon our intrastate electric utilities. To foreclose this uncomfortable possibility, state regulatory agencies must include anticompetitive considerations in their public interest rulings, for the "public interest" does encompass and merit such a consideration.[368] Congress has echoed this sentiment in the licensing requirements of the Atomic Energy Act.[369] Moreover, in some instances, the courts have required regu-

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[360] NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 44.

[361] Kestenbaum, *supra* note 339, at 370; *see* Handler, *supra* note 333, at 205.

[362] COUNCIL OF ECONOMIC ADVISORS ANNUAL REPORT 106-07 (1970).

[363] *Id.* at 108.

[364] Rogers, *Mergers in Regulated Industries: The Role of the Regulatory Agency*, 7 ST. MARY'S L.J. 297, 316 (1975).

The failure of agencies to deal satisfactorily with the competition aspects of utility regulation may be the result of opposition to competition by the regulated industries themselves. *See* PRESIDENTIAL TASK FORCE, REPORT ON ANTITRUST POLICY (July 5, 1968).

[365] Handler, *supra* note 333, at 206.

[366] Clayton Act, 15 U.S.C. §§ 12 *et seq.* (1970); Sherman Act §§ 1-7, 15 U.S.C. §§ 1-7 (1970).

[367] *See* Handler, *supra* note 333, at 206.

[368] *See* FCC v. RCA Communications, Inc., 346 U.S. 86, 94 (1953)("There can be no doubt that competition is a relevant factor in weighing the public interests.").

[369] Atomic Energy Act § 105(c), 42 U.S.C. § 2135(c)(1970).

latory agencies to consider antitrust principles when ruling in the public interest.[370] The reason therefor has been aptly stated by the United States Supreme Court in *Gulf States Utilities Company v. FPC*:[371]

> Consideration of antitrust and anticompetitive issues by the [regulatory agency], moreover, serves the important function of establishing a first line of defense against those competitive practices that might later be the subject of antitrust proceedings.[372]

Today, nearly every regulatory decision bearing on the "public interest" takes into account some competitive consideration along with other regulatory factors and policies.[373] The Mississippi Supreme Court did as much when it stated in the *South Mississippi* case:

> Do the [private power companies] by their certificated rights to sell, which we have held to be valuable, acquire by the certificates the absolute right to continue these sales to a utility which desires to generate its own electricity . . .? An affirmative answer to this question would indeed render the petitioners captive customers of the [companies] who are in reality their competitors. We find no comfort in the authorities cited by counsel nor were we able to find direct authorities by our own research to answer this perplexing question.[374]

Therefore, the issue is not so much whether antitrust principles *are* being applied,[375] but is rather to what extent should they be applied to regulated industries.[376]

The "perplexing question" posed in the above quotation demonstrates the historical tendency of our courts and agencies to overlook antitrust principles in regulatory decisions,[377] particularly in light of

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[370] *See, e.g.*, Gulf States Util. Co. v. FPC, 411 U.S. 747 (1973); Federal Maritime Comm'n v. Aktiebolaget Svenska Amerika Linien, 390 U.S. 238 (1968); Denver & R.G. W. R. R. v. United States, 387 U.S. 485 (1967); United States v. Radio Corp. of America, 358 U.S. 334 (1959); Sabin v. Butz, 515 F.2d 1061 (10th Cir. 1975); Northern Cal. Power Agency v. Public Util. Comm'n, 5 Cal. 3d 370, 486 P.2d 1218, 96 Cal. Rptr. 18 (Sup. Ct. 1971).

[371] 411 U.S. 747 (1973).

[372] *Id.* at 760.

[373] Handler, *supra* note 333, at 193.

[374] Mississippi Power Co. v. South Miss. Elec. Power Ass'n, 254 Miss. 754, 773, 183 So. 2d 163, 170, *cert. denied*, 385 U.S. 823 (1966). The court also disclaimed application of the *Tri-State Transit* rule to wholesale sales of electricity in Mississippi. *Id.*

[375] Even a decision that no competition will be allowed is such a determination.

[376] *See* Handler, *supra* note 333, at 194.

[377] [T]he history of the United States regulatory agencies in general seems usually to record an ever growing absence of the spirit required for vigorous enforcement of the antitrust laws. Rather, it seems to demonstrate that shortly following the establishment of administrative procedures, the regulatory agency usually becomes dominated by the industry which it was created to regulate.

traditional views of the electric utility industry as a natural monopoly.[378] The probable reason for this is that, formerly, "antitrust and regulation were regarded as more or less mutually exclusive."[379] Antitrust laws were to apply to free enterprise as a means of indirect regulation, and state agencies were to implement direct regulation over the regulated industries by use of special rules consistent with that purpose.[380] One observer has remarked that "the Congress that passed the Sherman Act undoubtedly believed that a clear dichotomy existed between the public utilities and commerce and industry in general."[381]

The difficulty in applying antitrust principles in the regulatory sector arises from the need to "reconcile" the antitrust goals of "eliminating restraints on competition" with the often anticompetitive effects of regulation.[382] However,

> the basic goal of direct government regulation through regulatory bodies and the goal of indirect governmental regulation in the form of antitrust law is the same—to achieve the most efficient allocation of resources possible.[383]

Therefore, the economic goals of antitrust and regulation may frequently coincide and complement each other, even when considering the public interest.[384] At least one United States Supreme Court decision has discussed the desirability of coexistence of antitrust principles and regulatory policies.[385] Present methods for reconciling these two principles, however, are "grossly inadequate."[386]

Thill Sec. Corp. v. New York Stock Exch., 433 F.2d 264, 273 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

[378] *See* Meeks, *supra* note 46, at 65.

[379] Remarks of E. Pollock, *supra* note 334, at 275; *see* Meeks, *supra* note 46, at 76.

[380] Meeks, *supra* note 46, at 76. Antitrust seems to apply more often where "regulatory presence is much less noticeable." Kestenbaum, *supra* note 339, at 377.

[381] First, *Private Interest and Public Control: Government Action, the First Amendment, and the Sherman Act*, 1975 UTAH L. REV. 9, 15.

[382] Silver v. New York Stock Exch., 373 U.S. 341, 349 (1963).

[383] Northern Natural Gas Co. v. FPC, 399 F.2d 953, 959 (D.C. Cir. 1968)(footnote omitted).

[384] First, *supra* note 381, at 10; Meeks, *supra* note 46, at 76.

[385] United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 372 (1963)("The fact that banking is a highly regulated industry critical to the Nation's welfare makes the play of competition not less important but more so."). For Mississippi's counterpart to this decision, see Hancock Bank v. Gaddy, 328 So. 2d 361 (Miss. 1976). Antitrust laws have been applied in the following regulated industries: Otter Tail Power Co. v. United States, 410 U.S. 366 (1973) (electric utility industry); Carnation Co. v. Pacific Westbound Conference, 383 U.S. 213 (1966)(ocean carriers); United States v. El Paso Natural Gas, 376 U.S. 651 (1964)(natural gas pipelines); Silver v. New York Stock Exch., 373 U.S. 341 (1963) (securities).

[386] Handler, *supra* note 333, at 194; *see* Kestenbaum, *supra* note 339, at 377.

Determining the extent to which antitrust principles may be applied to the electric utility industry does not end the inquiry. One must also ask what *type* of antitrust policy is desirable. One commentator has suggested that "an appropriate antitrust policy for the electric power industry is one that preserves that degree of competition consonant with realization of economies of scale."[387] It should be noted, however, that not all regulatory agencies are given the power to enforce the antitrust laws.[388] Nevertheless, anticompetitive factors molded by the antitrust laws themselves may be taken into account to achieve the same result.

Federal statutes dealing with the interstate electric power industry contain no express antitrust exemptions.[389] The electric utility industry is subject to federal antitrust laws except as otherwise specifically provided by Congress.[390] In *Gulf States Utilities Co. v. FPC*,[391] for example, the Supreme Court recognized that principles of limited competition can apply to regulated monopolies.[392] In addition, antitrust laws have been invoked to control electric utility competition with other markets.[393] Within the electric utility industry itself, antitrust laws may be applied to the wholesale market,[394] mergers,[395] and refusals by private

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[387] Meeks, *supra* note 46, at 75.

[388] *See* Handler, *supra* note 333, at 203.

[389] Kestenbaum, *supra* note 339, at 377. *See* Federal Power Act, 16 U.S.C. §§ 791a *et seq.* (1970).

[390] *See* Otter Tail Power Co. v. United States, 410 U.S. 366 (1973); Pennsylvania Water & Supply Co. v. Consolidated Gas, Elec. Light & Power Co., 184 F.2d 552, 560 (4th Cir.), *cert. denied,* 340 U.S. 906 (1950).

[391] 411 U.S. 747 (1973).

[392] Gulf States proposed a bond issue, to which Louisiana Electric responded with an action under 16 U.S.C. § 824(c)(1970), which gives the FPC jurisdiction to examine each bond issue proposal and decide if it is necessary. When the FPC held that allegations of anticompetitive practices were irrelevant to bond issue requests, the Supreme Court reversed, holding:

> The [Federal Power Act] did not render antitrust policy irrelevant to the Commission's regulation of the electric power industry. Indeed, within the confines of a basic natural monopoly structure, limited competition of the sort protected by the antitrust laws seems to have been anticipated.

411 U.S. at 759. The FPC must consider antitrust and anticompetitive issues. *Id.* at 760.

[393] *See* Washington Gas Light Co. v. Virginia Elec. & Power Co., 438 F.2d 248 (4th Cir. 1971); Alabama Power Co. v. Alabama Elec. Cooperative, Inc., 394 F.2d 672 (5th Cir. 1968), *cert. denied,* 393 U.S. 488 (1969); Pennsylvania Water & Power Co. v. Consolidated Gas, Elec. Light & Power Co., 184 F.2d 552 (4th Cir.), *cert. denied,* 340 U.S. 906 (1950). *See generally* Comment, *supra* note 49, at 799-800.

[394] Otter Tail Power Co. v. United States, 410 U.S. 366 (1973); *see Re* Mississippi Power Co., 88 P.U.R.3d 417, 426 (FPC 1971); Kestenbaum, *supra* note 339, at 375.

[395] *Cf.* United States v. El Paso Natural Gas Co., 376 U.S. 651 (1964)(antitrust laws apply to merger of natural gas companies); United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 353-54 (1963) (merger of banks comes within section 7 of the Clayton Act); International Tel. & Tel. Corp. v. General Tel. & Elec. Corp., 518 F.2d 913, 935 (9th Cir.

companies to deal with municipalities.[396] When presented with an antitrust claim against a regulated industry, a court must correctly define the relevant markets of the product;[397] therefore, other markets[398] available in the electric power industry may present opportunities for the application of antitrust law.

Even when a regulated industry is subject to antitrust laws, it may nevertheless escape their application. Where state regulatory action results in anticompetitive behavior, such as granting a geographic monopoly to an electric utility, the courts consider three major principles before invoking the antitrust laws: (1) whether state legislation under which the anticompetitive behavior is sanctioned accomplishes the sought-after goal; (2) the primary jurisdiction doctrine; and (3) the state action doctrine.[399]

The initial inquiry is whether the regulatory statute prevents antitrust application or discussion by the agency[400] and whether the anticompetitive means employed by the state agency actually accomplish the desired result.[401] However, "[s]tate regulatory statutes . . . are rarely subjected to thorough inquiry because the federal courts are insensitive to the prerogatives of state regulatory agencies."[402] Thus, the courts fail to develop a clear understanding of state legislative policy involved in the anticompetitive regulatory conduct.[403]

Next, there is the primary jurisdiction doctrine by which courts defer to the continuing jurisdiction of the regulatory agency and its well-developed and "unique expertise" in dealing with the particular industry.[404] Again, however, the courts' failure to delve into how the state

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1975)(antitrust laws apply to merger of communication companies). *See also* Rogers, *supra* note 364.

[396] Otter Tail Power Co. v. United States, 410 U.S. 366 (1973); *see* Kestenbaum, *supra* note 339, at 375.

[397] International Tel. & Tel. Corp. v. General Tel. & Elec. Corp., 518 F.2d 913, 932-33, 937-38 (9th Cir. 1975).

[398] See notes 352 through 357 and accompanying text *supra*.

[399] *See generally* First, *supra* note 381, at 34-36. Because of these "obstacles" the courts have been more willing to apply antitrust laws against industries under federal, as opposed to state, regulation. *Id.*

[400] *Id.*; *see* Gas Light Co. v. Georgia Power Co., 440 F.2d 1135 (5th Cir. 1971), *cert. denied*, 404 U.S. 1062 (1972); Washington Gas Light Co. v. Virginia Elec. & Power Co., 438 F.2d 248 (4th Cir. 1971).

[401] Comment, *Federal Antitrust Policy v. State Anticompetitive Regulation: A Means Scrutiny Limit for* Parker v. Brown, 1975 UTAH L. REV. 179, 187-88; *see* Allstate Ins. Co. v. Lanier, 361 F.2d 870, 871-72 (4th Cir.), *cert. denied*, 385 U.S. 930 (1966); Travelers Ins. Co. v. Blue Cross, 298 F. Supp. 1109 (W.D. Pa. 1969).

[402] First, *supra* note 381, at 35 & n.188.

[403] *Id.*

[404] Comment, *supra* note 49, at 799; *see* Far East Movers Conference v. United States, 342 U.S. 570, 574-75 (1952).

regulatory agencies evaluate their policies toward anticompetitive issues has inhibited development of the primary jurisdiction doctrine, "and thus little incentive [exists] for courts to scrutinize the specifics of the state regulatory schemes involved."[405]

Finally, the courts look to the state action doctrine which is based on the premise that "when a state grants monopoly powers to a private business, the activities of the private business are really the activities of the state itself . . . ."[406] The applicability of federal antitrust law, therefore, depends on the degree of state control[407] and whether such control performs the antitrust functions.[408]

The state action doctrine—the means most often used by electric utilities to avoid antitrust action—originated with *Parker v. Brown,*[409] where the United States Supreme Court held that a business can avoid antitrust liability where the state, acting as sovereign, imposes the anticompetitive action.[410] A component of the *Parker* immunity is that the means of the regulation constitute "affirmative state regulation."[411] Thus, in searching for state action, the question becomes what government action is enough to confer antitrust immunity. Recent decisions attempting to resolve this issue have held that the exemption applies only where there is deliberate state action substituting regulation for competition,[412] or where there is actual state supervision of anticompetitive activities.[413] In the recent case of *Goldfarb v. Virginia State Bar,*[414] the Court added that "[i]t is not enough that . . . anticompetitive conduct is 'prompted' by state action; rather, anticompetitive activities must be compelled by direction of the State acting as a sovereign,"[415] as opposed to mere state indifference toward anticompetitive conduct.[416]

Thus, a reviewing court must initially determine whether the anti-

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[405] First, *supra* note 381, at 35 & n.188.

[406] Comment, *supra* note 49, at 799; *see* Parker v. Brown, 317 U.S. 341, 350-52 (1943); Simmons & Fornaciari, *State Regulation as an Antitrust Defense: An Analysis of the* Parker v. Brown *Doctrine,* 43 U. CIN. L. REV. 61, 95 (1974).

[407] Comment, *supra* note 277, at 348.

[408] *See* Silver v. New York Stock Exch., 373 U.S. 341, 358 (1963).

[409] 317 U.S. 341 (1943).

[410] *Id.* at 352.

[411] Comment, *supra* note 401, at 188; *see* Handler, *Twenty-Fourth Annual Antitrust Review,* 72 COLUM. L. REV. 1, 6-7 (1972).

[412] *See* New Mexico v. American Petrofina, Inc., 501 F.2d 363, 369-70 (9th Cir. 1974); George R. Whitten, Jr., Inc. v. Paddock Pool Builders, Inc., 424 F.2d 25, 30 (1st Cir.), *cert. denied,* 400 U.S. 580 (1970).

[413] Washington Gas Light Co. v. Virginia Elec. & Power Co., 438 F.2d 248 (4th Cir. 1971).

[414] 421 U.S. 773 (1975).

[415] *Id.* at 791.

[416] *See* United States v. Borden Co., 308 U.S. 188 (1939).

competitive activity is actually required by the state.[417] Under this test, a court would have to find an "intent of the state to restrain competition in a given area" before *Parker* immunity will be extended.[418] Clearly, the application of a rate structure to a public utility such as an electric company would satisfy this requirement.[419] A serious question exists, however, as to how far *Parker* immunity should be extended beyond rate regulation;[420] legal scholars and economists are currently expressing great concern over problems with antitrust immunities and the regulatory agencies.[421] Moreover, *Parker* itself did not provide guidelines for determining the *kind* of state action required to satisfy the exemption.[422] Where the state action is "so ill-advised as to serve no state purpose," *Parker* cannot be invoked.[423]

Other types of "state action" which are insufficient to satisfy *Parker* immunity result where state agencies "make little or no effort to ensure the maintenance of competition in the . . . field"[424] and where the industry provides the regulatory agency with falsified data which is used in reaching a public interest decision.[425] One writer has gone so far as to suggest that the Sherman Act should preempt any state regulatory action which interferes with its policies,[426] while another[427] has argued

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[417] Goldfarb v. Virginia State Bar, 421 U.S. 773, 790 (1975).

[418] Duke & Co. v. Foerster, 521 F.2d 1277, 1280 (3rd Cir. 1975).

[419] *See* Jeffrey v. Southwestern Bell, 518 F.2d 1129, 1133-34 (5th Cir. 1975); Gas Light Co. v. Georgia Power Co., 440 F.2d 1135, 1140 (5th Cir. 1971), *cert. denied,* 404 U.S. 1062 (1972); Region Properties, Inc. v. Appalachian Power Co., 368 F. Supp. 630 (W.D. Va. 1973).

[420] For example, rural cooperatives which are not under full control of the state regulatory agency would arguably *not* be granted *Parker* immunity. *See* Comment, *supra* note 277, at 350. Mississippi's rural cooperatives are not fully regulated by the Public Service Commission. *See* MISS. CODE ANN. § 77-3-5(6)(1972) (public service commission cannot regulate a cooperative's rates). Therefore, it is possible that *Parker* immunity would not extend to rural electric cooperatives in Mississippi. *See also* NLRB v. Natchez Trace Elec. Power Ass'n, 476 F.2d 1042 (5th Cir. 1973) (Mississippi electric cooperative is not a state political subdivision, nor does it possess characterics of such).

[421] *E.g.,* Kauper, *Department of Justice: Antitrust Prospective,* 36 U. PITT. L. REV. 667 (1975); Kauper, *National Energy Policy and the Antitrust Laws,* 15 ATOMIC ENERGY L.J. 265 (1973); Samuels, *Public Utility Ratemaking and Competitive Structure*—Carterfone *in Jeopardy,* 20 WAYNE L. REV. 819 (1974); Slater, *supra* note 342.

[422] *See* Comment, *supra* note 401, at 187.

[423] Slater, *supra* note 342, at 97-101.

[424] International Tel. & Tel. Corp. v. General Tel. & Elec. Corp., 518 F.2d 913, 936 (9th Cir. 1975).

[425] Wood Exporation and Producing Co. v. Aluminum Co. of America, 438 F.2d 1286 (5th Cir. 1971), *cert. denied,* 404 U.S. 1047 (1972).

[426] First, *supra* note 381, at 41-44; *see* Northern Sec. Co. v. United States, 193 U.S. 197 (1904)(Harlan, J.).

[427] *See* Note, *The State Action Exemption and Antitrust Enforcement Under the Federal Trade Commission Act,* 89 HARV. L. REV. 715 (1976).

convincingly that *Parker* does not immunize the state from "unfair methods of competition . . . in or affecting commerce" within section 5 of the Federal Trade Commission Act.[428]

The *Parker* state action doctrine was significantly narrowed in *Cantor v. Detroit Edison Co.*[428.1] decided during the early printing stages of this article. Although the Court was closely divided,[428.2] *Cantor* seems to say that exemption from federal antitrust laws will be allowed only where "necessary in order to make the [state] regulatory act work, 'and even then only to the minimum extent necessary.'"[428.3] Thus, the mere fact that a state regulatory body approves and directs private anticompetitive behavior does not grant antitrust immunity to a regulated industry.

In discussing the applicability of antitrust principles to regulated industries the Court noted:

> There is no logical inconsistency between requiring [a public utility] to meet regulatory criteria in so far as it is exercising its natural monopoly powers and also to comply with antitrust standards *to the extent that it engages in business activity in competitive areas of the economy.* Thus . . . regulation of [the] distribution of electricity poses no necessary conflict with a federal requirement that [a public utility's] activities in competitive markets satisfy antitrust standards.[428.4]

This significant language should lead to investigations of regulated industries to determine relevant markets for the enforcement of beneficial competition.[428.5]

Cantor provides the springboard for the eventual development of the primary jurisdiction doctrine in state regulation. State regulatory bodies must consider the effects of their determinations upon announced antitrust goals. As a collateral result, industries regulated under the primary jurisdiction doctrine may avoid antitrust liability where the state agency, weighing antitrust implications, has directed anticompetitive behavior.

V. Federal Preemption and the Federal Power Act

The Federal Power Act[429] gives the Federal Power Commission juris-

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[428] 15 U.S.C. § 45(a)(1) (Supp. V, 1975).

[428.1] 44 U.S.L.W. 5357 (U.S. July 6, 1976).

[428.2] Joining in Mr. Justice Stevens' opinion for the Court were Mr. Justices Brennan, White, and Marshall. Mr. Chief Justice Burger concurred in the judgment and concurred in part. *Id.* at 5364. Mr. Justice Blackmun concurred in the judgment in a separate opinion. *Id.* at 5365. Mr. Justice Stewart voiced a vociferous dissent in which Mr. Justices Powell and Rehnquist joined. *Id.* at 5368.

[428.3] *Id.* at 5362-63.

[428.4] *Id.* at 5362 (footnotes omitted) (emphasis added).

[428.5] See notes 349 through 359 and accompanying text *supra.*

[429] 16 U.S.C. §§ 791a *et seq.* (1970).

diction over electric power companies which fall within the category of a "public utility." Public utility is defined in the Act as any person owning or operating facilities for the "transmission of electric energy in interstate commerce and . . . the sale of electric energy at wholesale in interstate commerce . . . ."[430] FPC jurisdiction thus involves a dual standard based alternatively on facilities or wholesale sales of electricity.[431] The traditional view of the scope of FPC jurisdiction, however, emphasizes the *type* of facilities rather than the mode of business.[432] Therefore, a company may be subject to federal regulation by owning facilities for transmitting electricity in interstate commerce *or* by owning facilities for the sale of electrical energy at wholesale in interstate commerce.[433] This conclusion has led to the current belief that the state has jurisdiction over electric utility systems operating at the retail level as local monopolies and that the FPC has jurisdiction at the wholesale level.[434] However, as more power systems are brought into interstate power pools there is speculation that the FPC has potential jurisdiction over every major power facility in the country.[435]

Conflicts have arisen over federal and state jurisdiction in the regulation of wholesale sales of electricity as governed in section 201(b) of the Federal Power Act.[436] Wholesale sales of electrical power in inter-

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[430] 16 U.S.C. § 824(b)(1970); *cf.* FPC v. East Ohio Gas Co., 338 U.S. 464, 468 (1950).

[431] 46 B.U.L. Rev. 552 (1966); *see* R. Baum, The Federal Power Commission and State Utility Regulation 56 (1942).

[432] R. Baum, *supra* note 431, at 56; Note, *Electric Utility Jurisdiction of the Federal Power Commission,* 40 N.Y.U.L. Rev. 1129, 1130-31 (1965).

[433] R. Baum, *supra* note 431, at 56. Jurisdiction over interstate facilities, however, is not necessarily dispositive of federal jurisdiction over wholesale sales. FPC jurisdiction may be asserted over facilities used for wholesale sales of electricity even if a particular company has no interstate facilities for transmission. *See* Jersey Cent. Power & Light Co. v. FPC, 319 U.S. 61 (1943). The "facilities" of an electric power company in interstate commerce subject to FPC jurisdiction include power lines transmitting the energy, Jersey Cent. Power & Light Co. v. FPC, 319 U.S. 61 (1943), and meters, transformers, and bus bars. Florida Pub. Util. Comm'n, 9 F.P.C. 3, 11-12 (1950). In certain circumstances, contracts, memoranda, papers, and other records have been held to be "facilities" over which federal jurisdiction may be asserted. Hartford Elec. Light Co. v. FPC, 131 F.2d 953, 961 (2d Cir. 1942), *cert. denied,* 319 U.S. 741 (1943).

[434] Nuclear Regulatory Commission, *supra* note 335, at 1.

[435] *See* Breyer & MacAvoy, *The Federal Power Commission and the Coordination Problems in the Electric Utility Industry,* 46 S. Cal. L. Rev. 661, 697 (1973); Miller, *supra* note 104, at 640 n.30 (1970); Note, *supra* note 432, at 1152; *cf.* Foster, Garfield & Herz, *FPC Regulation of Sales of Electric Energy at Wholesale,* 51 Va. L. Rev. 76, 78 (1965).

[436] 16 U.S.C. § 824 (1970). Wholesale sales of electricity arise in three jurisdictional circumstances: (1) where an electric power company sells all or substantially all of its generated power at wholesale in interstate commerce; (2) where wholesale sales are a minor part of a company's business; and (3) where transmission occurs via electrical interchange in interconnected pooling systems. Foster, Garfield & Herz, *supra* note 435, at 83.

state commerce have been held to be within the exclusive control of the federal government.[437] The FPC may exercise jurisdiction when evidence supports the conclusion that energy has been transmitted in interstate commerce,[438] which occurs when electricity is "transmitted from a State and consumed at any point outside thereof."[439] Any wholesale sale in interstate commerce made by an electric utility is subject to FPC jurisdiction. This is true even though the transmission occurs over lines used for retail sales[440] or only a small quantity of electricity is involved.[441]

The question of whether energy has crossed state lines is central to an assertion of FPC jurisdiction. The test for this determination is ideally "an engineering and scientific, rather than a legalistic or governmental, test."[442] Yet, because the scientific basis for actually measuring

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[437] United States v. Public Util. Comm'n, 345 U.S. 295, 308, 311 (1953); *see* Panhandle E. Pipe Co. v. Puhlic Serv. Comm'n, 332 U.S. 507, 516-17 (1947). There are two requisites hefore the FPC can set wholesale rates: (1) a sale must be made by a company which falls in a category of a "public utility"; and (2) the *sale* must be subject to FPC jurisdiction within the terms of the Federal Power Act. 16 U.S.C. §§ 824(d)-(e)(1970). A company may file its wholesale rates with the FPC, while reserving the question of jurisdiction for later adjudication. *See* Note, *supra* note 432, at 1138. Final orders of the FPC are reviewahle by the federal courts of appeals and the United States Supreme Court. 16 U.S.C. § 825*l* (1970); *see* R. BAUM, *supra* note 431, at 66.

[438] FPC v. Florida Power & Light Co., 404 U.S. 453, 458 (1972). It is assumed that judges lack technological expertise in matters of transmission; therefore, findings of fact hy the FPC are conclusive if supported by "substantial evidence." Public Serv. Comm'n v. FPC, 375 F.2d 100, 103 (7th Cir. 1967); *Re* Cincinnati Gas & Elec. Co., 62 P.U.R.3d 179 (FPC 1966).

[439] Jersey Cent. Power & Light Co. v. FPC, 319 U.S. 61, 71 (1943); *see* California v. Lo-Vaca Gathering Co., 379 U.S. 366, 369 (1965). The company does not have to own or operate facilities actually located across state lines. Therefore, federal jurisdiction attaches at the sale of locally produced energy when it is produced with the knowledge that the huyer will use it outside the state. Jersey Cent. Power & Light Co. v. FPC, *supra,* at 71-72.

[440] 46 B.U.L. REV. 552, 560 (1966); *see* Pennsylvania Water & Power Co. v. FPC, 343 U.S. 414, 419-20 (1952).

[441] FPC v. Southern Cal. Edison Co., 376 U.S. 205, 209 n.5 (1964); Connecticut Light & Power Co. v. FPC, 324 U.S. 515, 535-36 (1945); Wisconsin v. FPC, 197 F.2d 472, 477-78 (7th Cir. 1952), *cert. denied*, 345 U.S. 934 (1953); *see* Note, *supra* note 432, at 1132. Until 10 years ago, however, wholesale sales of electric power, which had taken place in a single state where only a fractional amount of energy had originated from out-of-state, were viewed as a state regulatory matter. *See* Foster, Garfield & Herz, *supra* note 435, at 76; *cf.* FPC v. Southern Cal. Edison Co., *supra.*

[442] Connecticut Light & Power Co. v. FPC, 324 U.S. 515, 529 (1945); *accord* California Lo-Vaca Gathering Co. v. FPC, 379 U.S. 366, 369 (1965). *See generally* Note, *supra* note 432, at 1143-54. The FPC has employed three tests by which to follow the flow of electricity in interstate commerce: (1) The "tracing theory," no longer used, is based on the physical tracing of out-of-state energy to the particular sale involved, *see* Connecticut Light & Power Co. v. FPC, 324 U.S. 515, 529 (1945); Note, *supra* note 432, at 1144-45; 46 WASH. L. REV. 837, 838 (1971). *See also* Breyer & MacAvoy, *supra* note 435, at 662; (2) The "commingling theory," which

deliveries of electricity in interstate commerce is uncertain,[443] the FPC has employed an "interstate power pooling" theory. This test, instead of attempting to trace the actual energy flow, seeks to invoke FPC jurisdiction over wholesale sales of electricity on the theory that the "commingling" of electricity through an integrated power pool system shows prima facie the interstate nature of the transmission.[444]

The advent of this theory was obviously the result of the FPC's findings in its National Power Survey that 97 percent of the United States' electricity is transmitted by interconnection.[445] Following a series of lower federal cases,[446] the United States Supreme Court finally adopted the interstate power pool theory in *FPC v. Florida Power & Light Co.*[447] Florida Power & Light (FP&L) generated, transmitted, and sold electricity solely within Florida. It was connected, in a power pool, to four other electrical systems within Florida. Only one of these four systems was connected to an interstate power pool.[448] FP&L had no direct connection with an out-of-state facility and had no contracts to sell electricity out-of-state. Although the FPC could not show an actual flow of electricity in interstate commerce, it asserted that any facility connected to a facility selling electricity in interstate commerce is per se in interstate commerce. The FPC's rationale was that FP&L operated in "electromagnetic unity" with suppliers outside of Florida, and that FP&L was hooked up in an interconnection which commingled the power of all the systems.[449]

The Court, reversing the Fifth Circuit's denial of FPC jurisdiction

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assumes that if out-of-state energy constitutes a specific fraction of the energy delivered to a bus bar, all loads served through that bus bar will be served by the same proportions of out-of-state and in-state energy as are delivered to that bus bar.

Note, *supra* note 432, at 1150; *see* FPC v. Southern Cal. Edison Co., 376 U.S. 205 (1964). *See also* 46 WASH. L. REV. 837, 839-40 (1971); and (3) The "interstate power pool" theory, which is discussed in the text.

[443] *See* Breyer & MacAvoy, *supra* note 435, at 697; Note, *supra* note 432, at 1150-51.

[444] *See* 46 B.U.L. REV. 552, 562, 564 (1966). Elements scrutinized by the FPC in employing the power pool theory are: (1) centralized management; (2) the maintenance of a billing system indicating interstate sales; and (3) a synchronization of cycle frequencies throughout the system. *Id.* at 564.

[445] FPC, NATIONAL POWER SURVEY 14 (1964); *cf.* Note, *supra* note 432, at 1141.

[446] Public Serv. Co. v. FPC, 375 F.2d 100 (7th Cir. 1967); Arkansas Power & Light Co. v. FPC, 368 F.2d 376 (8th Cir. 1966); Indiana & Mich. Elec. Co. v. FPC, 365 F.2d 180 (7th Cir.), *cert. denied*, 385 U.S. 972 (1966).

[447] 404 U.S. 453 (1972).

[448] The electric power generation for all systems equaled 60 cycle frequencies, creating an automatic free flow of electricity throughout the network of all systems, and beyond the regulation of any one system. *Id.* at 460.

[449] *Id.* at 460-61.

over FP&L,[450] held that the "commingling theory," by which the flow of electricity in interstate commerce is measured,[451] was an adequate basis for asserting FPC jurisdiction. The Court reasoned that expert testimony, "uncontradicted by empirical evidence," is acceptable as "substantial evidence" of transmission in interstate commerce.[452] To satisfy this requirement, the FTC need only show, without tracing the flow, that FP&L electrical energy entered and left a power bus which was simultaneously transmitting power to an out-of-state destination.[453] As the quantity of the energy flowing interstate—however minute—did not matter, FPC jurisdiction attached under the "owns and operates facilities for the interstate transmission of electrical energy" provision of the Federal Power Act.[454] In addition, the Court recognized that the growth of interstate power pools necessitated increased federal regulation.[455] Thus, the FPC's jurisdiction may attach where an electric power company's interstate sales of electricity are at best indirect and constitute only a small part of the utility's business.[456]

The states are allowed to retain jurisdiction over retail sales of electricity under section 201(b) of the Federal Power Act, which provides for the exemption from FPC jurisdiction of "facilities used in local distribution" of electrical energy.[457] The United States Supreme Court, in *Connecticut Light & Power Co. v. FPC*,[458] interpreted the "local distribution exception" as meaning that the exemption from FPC jurisdic-

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[450] Florida Power & Light Co. v. FPC, 430 F.2d 1377 (5th Cir. 1970), *rev'd*, 404 U.S. 453 (1972).

[451] See note 442 *supra*.

[452] 404 U.S. at 464-65.

[453] *Id.* at 461.

[454] *Id.* at 461 n.10.

[455] *Id.* at 468.

[456] Private companies have tried to escape FPC jurisdiction by relying on Section 201(a) of the Federal Power Act, which appears to declare that those areas which have been previously regulated by the states will remain within state jurisdiction. 16 U.S.C. § 824(a) (1970). But it has been held that if a company is a "public utility" within the context of section 201(b), 16 U.S.C. § 824(b)(1970), which grants federal jurisdiction over all sales of power in interstate commerce, previous state regulation does not matter. FPC v. Southern Cal. Edison Co., 376 U.S. 205, 210 (1964); United States v. Public Util. Comm'n, 345 U.S. 295, 303-04 (1953). One authority notes that rather than depriving the FPC of any authority, section 201(a) merely states a general policy of jurisdiction. R. *Baum*, *supra* note 431, at 63. And, in Connecticut Light & Power Co. v. FPC, 324 U.S. 515 (1954), the Court stated: -

> The policy declaration that federal regulation is "to extend only to those matters which are not subject to regulation by the States" is one of great generality. It cannot nullify a clear and specific grant of jurisdiction, even if the particular grant seems inconsistent with the broadly expressed purpose.

Id. at 527. *See also* Public Serv. Co. v. FPC, 375 F.2d 100 (7th Cir. 1967).

[457] 16 U.S.C. § 824(b)(1970).

[458] 324 U.S. 515 (1945).

tion applies to wholesale purchasers of interstate energy who deal only in the local distribution of such energy. The Court distinguished between the FPC's wholesale sales jurisdiction and the FPC's facilities jurisdiction, applying the exception to the latter.[459]

The United States Court of Appeals for the Seventh Circuit has interpreted "facilities used in local distribution" to mean

> facilities used for making resale and distribution to consumers, jurisdiction over which is left to the states. . . . We think there is no ground for the position that local distribution includes any transmission occurring before the wholesaler who resells at retail is reached.[460]

The question, therefore, becomes one of when interstate transmission ends and local distribution begins.[461]

Because the Court has held the local distribution exception to apply in determining "public utility" status and not to sales jurisdiction under the Act, it follows that wholesale sales of electricity in interstate commerce are subject to FPC jurisdiction *unless* the facilities are used for local distribution.[462] Accordingly, it is conceivable that intrastate facilities carrying electrical energy from wholesale sales in local distribution, even though the electricity is from out-of-state sources, are exempt from FPC jurisdiction. The Supreme Court intimated acceptance of this argument in *FPC v. Southern California Edison Co.*[463] The FPC has argued that exempting wholesale sales in this manner would abrogate the congressional intent to close the jurisdictional gap which was created by *Public Utility Commission v. Attleboro Steam & Electric Co.*[464] Others assert, however, that the exemption evidences a congressional intent to retain some state regulation.[465] Nevertheless, the safe harbor

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[459] *Id.* at 529-31; *see* R. BAUM, *supra* note 431, at 56; Note, *supra* note 432, at 1155-56; 46 B.U.L. REV. 552, 560 (1966).

[460] Wisconsin-Michigan Power Co. v. FPC, 197 F.2d 472, 477 (7th Cir. 1952).

[461] Whether a company's facilities fall into the exception is a question of fact for the FPC. The Court has held it to be a "legal standard" which must be included in the search for jurisdiction vis-à-vis the "technological transmission test." FPC v. Southern Cal. Edison, 376 U.S. 205, 210 n.6 (1964).

[462] The Court accepted this view in Connecticut Light & Power Co. v. FPC, 324 U.S. 515 (1945).

[463] 376 U.S. 205, 210 n.6 (1964). *See generally* Note, *supra* note 432, at 1155.

[464] 273 U.S. 83 (1927)(sales for resale in interstate commerce not constitutionally subject to state regulation even in absence of congressional action); *see* Indiana & Mich. Elec. Co. v. FPC, 365 F.2d 180 (7th Cir.), *cert. denied*, 385 U.S. 972 (1966). For a discussion of the gap created by *Attleboro* see Priest, *"Gaps" in the Regulatory Process and the Federal Dentist*, Parts I & II, 78 PUB. UTIL. FORT., No. 11, Nov. 24, 1966, at 15, No. 12, Dec. 8, 1966, at 32. *See generally* Powell, *Physics and Law—Commerce in Gas and Electricity—Interstate or Local*—Connecticut Light & Power Co. v. FPC, 58 HARV. L. REV. 1072 (1945); Note, *supra* note 432, at 1136.

[465] 46 B.U.L. REV. 552, 567 (1966).

from the FPC for local distributors who buy electricity at wholesale in interstate commerce is somewhat illusory since state jurisdiction remains subject to the far-reaching scope and limiting effect of the commerce clause.[466]

Another factor affecting state jurisdiction over electric utilities is section 202(b) of the Federal Power Act, empowering the FPC to order electric utilities under its jurisdiction to interconnect in times of emergency or upon application.[467] Before an interconnection can be ordered, however, the FPC must find that it: (1) promotes the public interest; (2) does not place an "undue burden" on the utility; (3) does not require the enlargement of generating facilities; and (4) does not impair the utility's ability to render "adequate services" to customers.[468] Interconnections between networks are desirable not only for economic reasons, but also for the prevention of power blackouts[469] and the promotion of regional power coordination.[470] Thus far, interconnection orders under section 202(b) have been limited.[471] As a result of the *Florida Power & Light* decision, however, the FPC could use section 202(b) to create even larger power pools through interconnections.[472]

It is not clear today what test is used to show *actual* transmission across state lines.[473] The new standard announced in *Florida Power & Light* appears to expand FPC jurisdiction over utilities which may be involved in *possible* sales of out-of-state energy because of the mere

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[466] *See* Tri-State Gen. & Transmission Ass'n v. Public Serv. Comm'n, 412 F.2d 115 (10th Cir. 1969). *See also* Buck v. Kuykendall, 267 U.S. 307, 315 (1925)(Brandeis, J.) (state's refusal to grant a certificate of public convenience and necessity for interstate motor carrier held a burden on interstate commerce on grounds that it prohibited competition).

[467] 16 U.S.C. §§ 824a-d (1970). *See generally* Comment, *Electric-Utility Interconnections: Power to the People,* 21 STAN. L. REV. 1714 (1969).

[468] Comment, *supra* note 467, at 1719.

[469] 46 WASH. L. REV. 837, 843 (1971).

[470] *See* FPC, NATIONAL POWER SURVEY 14-15 (1969); Breyer & MacAvoy, *supra* note 435, at 665; Comment, *supra* note 467, at 1717. *See generally* NUCLEAR REGULATORY COMMISSION, *supra* note 335, at 43-44.

[471] *See Hearings on H.R. 7186, H.R. 7016, H.R. 7052, and H.R. 9557 Before the Subcomm. on Communications and Power of the House Comm. on Interstate and Foreign Commerce,* 91st Cong., 1st Sess., pt. 1, at 10 (1969). Furthermore, proponents of the Federal Power Act of 1935 felt that although the FPC could order interconnection of private utilities, it could not order transmission of public generated power over their lines for sale in foreign jurisdictions. *See Hearings on H.R. 5423 Before the House Comm. on Interstate and Foreign Commerce,* 74th Cong., 1st Sess. pt. 1, at 532 (1935). *But cf.* Utah Power & Light Co. v. Morton, 504 F.2d 728 (9th Cir. 1974).

[472] Breyer & MacAvoy, *supra* note 435, at 697. This poses a danger in that the states may be induced to sever connections of intrastate companies from interstate power pools commingling energy from out-of-state. FPC v. Florida Power & Light Co., 404 U.S. 453, 475 (1972)(Douglas, J., dissenting).

[473] 46 WASH. L. REV. 837, 838 (1971).

presence of a power pool.[474] Although the extent of this jurisdiction is purportedly limited to accounting matters, mergers, and wholesale sales of electricity,[475] such an assertion of FPC jurisdiction appears to be neither grounded in the Federal Power Act nor founded upon any factual determination of actual transmission across state lines.[476] This new theory of jurisdiction departs from past Supreme Court rulings that federal jurisdiction follows the flow of electricity across state lines in a technological rather than a legal sense[477] and that "mere connection determines nothing."[478] The Court indicated in *Florida Power & Light* that the "scientific and engineering" test has been supplanted by the "substantial evidence" test, which connotes the adoption of a "legal or governmental" test.[479] As more power systems are interconnecting—thus being brought into interstate power pools—the *Florida Power & Light* rationale gives the FPC considerable opportunity to increase federal control over the electric power industry.[480]

As our nation's energy needs have become increasingly critical, a reorganization of the electric regulatory scheme has been suggested[481] in the pursuit of a national energy policy.[482] A national regulatory "super-agency" is necessary, some feel, because the electric power industry has outgrown the original scheme planned by Congress,[483] and because state

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[474] *See* 46 B.U.L. Rev. 552, 565-66 (1966).

[475] Breyer & MacAvoy, *supra* note 435, at 697.

[476] 46 B.U.L. Rev. 552, 565-66 (1966); *cf.* FPC v. Florida Power & Light Co., 404 U.S. 453, 476 (1972) (Douglas, J., dissenting).

[477] *See, e.g.,* Connecticut Light & Power Co. v. FPC, 324 U.S. 515, 529 (1945); *Re* Publ. Serv. Co., 62 P.U.R.3d 65, 80 (F.P.C. 1966) (O'Conner, Comm'r, dissenting and concurring).

[478] Jersey Cent. Power & Light Co. v. FPC, 319 U.S. 61, 72 (1943).

[479] See note 452 and accompanying text *supra*.

[480] Critics of this encroachment on state power regulation feel that interstate interconnection does not necessarily imply the flow of interstate power in a particular sale, and that FPC jurisdiction should not extend to sales not involving out-of-state power. Note, *supra* note 432, at 1143-47. State control, it is argued, should remain over companies whose activities are strictly local, even if a fraction of interstate energy flows into their systems. *Id.* at 1132. Under this argument, state control would be based on the local distribution exception.

Others view the FPC as providing a mere supplemental form of regulation, because retail sales remain to a great degree under state control. Breyer & MacAvoy, *supra* note 435, at 665, 697. This is based on the assumption that most privately owned companies are vertically integrated, receiving most of their revenues from the sales of self-generated power at retail. *See* Note, *supra* note 432, at 1135 n.51.

[481] *See* Bray, *supra* note 104, at 26, col. 5.

[482] *See* Doub, *Federal Energy Regulation—Toward a Better Way,* 60 A.B.A.J. 920, 922 (1974).

[483] *See* Miller, *supra* note 104, at 664-65; Tarlock, Tippy & Francis, *Environmental Regulation of Power Plant Siting: Existing and Proposed Institutions,* 45 S. Cal. L. Rev. 502, 505 (1972).

agencies have been unable to respond to the needs of the utilities and the consumers.[484] Also important, rates of return under FPC wholesale rates are generally lower than those for state regulated companies.[485] A less radical proposal calls for extension of FPC jurisdiction,[486] possibly ensuring and encouraging environmental policies and energy conservation.[487]

Opponents of increased FPC jurisdiction claim that: (1) federal regulation is costly for the regulated companies;[488] (2) competition would be discouraged;[489] (3) as interconnections have increased, wholesale sales of power have actually declined;[490] and (4) complete interconnection would be too expensive.[491] Another danger is that companies could try to utilize federal jurisdiction as a shield to escape traditional state jurisdiction over contract and tort matters.[492]

Nevertheless, the energy crisis facing this nation may bring about radical changes in the organization of the electric utility industry, even to the extent that federal regulation supplants state regulation. Harbingers of such a phenomenon include: (1) a recent Ford Foundation energy study calling for regional regulatory agencies to be overseen by a national review board;[493] (2) proposals that the federal government go into the electric wholesale business to aid construction growth and the busi-

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[484] Bray, *supra* note 104, at 1, col. 6; Miller, *supra* note 104, at 671; Note, *supra* note 432, at 1142. The inability of the states to meet utilities' money needs could cause cessation of generation plant construction, with the possible effect of undermining the nation's nuclear generation policy. Gannon, *A Friend in Need? Utilities' Financial Ills Stir White House Talk of Going to the Rescue*, Wall Street Journal, Feb. 18, 1975, at 1, col.6, 32, col.3.

[485] State regulatory agencies have exhibited a similar inability to protect the needs of the environment. Tarlock, Tippy & Francis, *supra* note 483, at 547-49; Note, *supra* note 432, at 1142.

[486] *See, e.g.*, Note, *supra* note 432, at 1134; 46 WASH. L. REV. 837, 844 (1971). It is calculated that by 1980 the FPC will have no jurisdiction over some 80 percent of generating capacity that will be produced by thermal power plants. *See* Miller, *supra* note 104, at 660.

[487] Bray, *supra* note 104, at 26, col. 6.

[488] Breyer & MacAvoy, *supra* note 435, at 669; Note, *supra* note 432, at 1132.

[489] Breyer & MacAvoy, *supra* note 435, at 669. *But see* Miller, *supra* note 104, at 644-45.

[490] Foster, Garfield & Herz, *supra* note 435, at 78-79.

[491] Breyer & MacAvoy, *supra* note 435, at 669.

[492] *See* Louisiana v. FPC, 503 F.2d 844, 849 (5th Cir. 1974).

There is an evident need for greater cooperation between state and federal regulatory agencies. *See* Doub, *supra* note 482, at 921; Foster, Garfield & Herz, *supra* note 435, at 103-04. Some utility companies have taken the initiative by forming regional councils for emergency purposes, and are proposing creation of a national agency to review adverse decisions of the state commission. Bray, *supra* note 104, at 26, col.5.

[493] *See* Bray, *supra* note 104, at 26, col.6.

ness ills of electric utilities;[494] and (3) a request from President Ford for congressional legislation designed to "streamline" present state regulation.[495] That Congress is able and willing to restrict state jurisdiction in addressing national energy needs is evidenced by the recent Alaskan Pipeline Amendment.[496]

Therefore, there are bases for federal preemption of electric utility regulation under the Federal Power Act and Congress' authority to regulate interstate commerce. Accordingly, there is a possibility that if the states do not respond to the demands of modern regulation, the FPC, with its judicial mandate to consider antitrust and anticompetitive aspects in matters within its jurisdiction,[497] may assert its power to force competition upon the electric utility industry once it is determined that such is needed within a given area.

Conclusion

The resolve to square regulatory and competitive policies must come from the legislature. The Mississippi Public Service Commission makes decisions affecting anticompetitive action in the electric utility field through the statute for certificates of public convenience and necessity. Therefore, the Mississippi Legislature should seriously consider alteration of this statute to allow reasonable competitive interaction in the electric utility industry, as an alternative to the monopoly concept. The state may still rely on *Nebbia v. New York*[498] to structure whatever economic policies reasonably promote the public welfare and *Parker v. Brown's*[499] authorization of economic experimentation by the states.

Whatever course is taken,

> [t]he more commanding the legislature's directive setting out an anticompetitive state policy, and the less it leaves to private discretion, the more likely it will be that such state laws will not be preempted [by federal antitrust laws].[500]

"Deregulation" in the form of compelling the public service commission to consider competitive or antitrust factors is most favorable not only

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[494] *See generally* Gannon, *supra* note 484.

[495] Bray, *supra* note 104, at 26, col. 6.

[496] Trans-Alaska Pipeline Authorization Act § 203(d), 43 U.S.C. § 1652(d)(Supp. IV, 1974). *See generally* Comment, *Congressional Power Over State and Federal Court Jurisdiction: The Hill-Burton and Trans-Alaska Pipeline Examples*, 49 N.Y.U.L. Rev. 131 (1974).

[497] *See* Gulf States Util. Co. v. FPC, 411 U.S. 747, 759-60 (1973); Alabama Power Co. v. FPC, 511 F.2d 383 (D.C. Cir. 1974).

[498] 291 U.S. 502 (1934).

[499] 317 U.S. 341, 351 (1943); see First, *supra* note 381, at 42-43.

[500] First, *supra* note 381, at 57-58.

because this is the crucial question when "government decision-making . . . affects market conditions,"[501] but also because it would be a step toward vesting primary jurisdiction of antitrust considerations in our state agency. The author hopes, therefore, that those responsible for maintaining effective and enlightened regulation of our public utilities will adopt the regulated competition concept for Mississippi's electric power industry.

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[501] *See* Kestenbaum, *supra* note 339, at 378.

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COMMENTS

VALUATION OF SHARES IN A CLOSELY HELD CORPORATION

Stock purchase agreements, appraisal statutes, estate taxes, and a variety of other situations[1] have often presented the courts with the challenging and confusing task of placing a value on shares of corporate stock. In addition to requiring an understanding of the principles of accounting, finance, and law, the process of determining a dollar amount which accurately reflects the value of corporate stock may be further complicated by the lack of a market value for the stock. Valuation is a relatively simple process if a market exists, either on a stock exchange or over-the-counter, since the selling price is usually accepted as the measure of value with little or no adjustment.[2] When the shares of a "closely held" corporation[3] are to be valued, however, the process is made more difficult by the absence of a recognized selling price. Current approaches to the valuation of shares in a closely held corporation utilize a host of factors and methods which are often highly sophisticated and confusing and add little certainty to an essentially inexact process.

The purpose of this comment is to provide a logical framework which will enable the practicing attorney to accurately and expeditiously value closely held shares. To accomplish this objective, situations which generally require valuation will be discussed as will the numerous factors and considerations important in any valuation of closely held shares. Furthermore, since most valuation problems arise out of taxable transfers of shares, existing Internal Revenue Service

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[1] Valuation of corporate stock is also necessary where the distribution of assets under a will is dependent on the value of the assets, Jenkins v. Young, 319 So. 2d 228 (Miss. 1975); for the levying of gift taxes; for stock option plans; for stock sales to key employees; for determining the exchange rate in a proposed merger; and for donations of stock to charitable institutions. *See* Banks, *Present Value and the Close Corporation*, 49 TAXES 33 (1971).

[2] For estate tax valuation, fair market value of stock for which there is a market is the mean between the highest and the lowest quoted selling prices on the valuation date. Treas. Reg. § 20.2031-2(b), 1974-2 CUM. BULL. 295.

The selling price of listed stock has been held to be the controlling factor in valuing a dissenter's stock under appraisal statutes. Note, *Valuation of Dissenter's Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453, 1462-63 (1966).

[3] The term "close" or "closely held" corporation has been defined in various ways. 1 F. O'NEAL, CLOSE CORPORATIONS § 1.02 (1971). Throughout this comment the term "closely held corporation" means a corporation which has few shareholders and whose shares are not generally traded in the securities market.

guidelines will be briefly examined. To emphasize the uncertainty which characterizes the valuation of closely held shares, a representative sample of judicial interpretations will be presented. In an attempt to provide a definite and feasible method for valuation, the weighted average method will be recommended. Finally, the authors will suggest a procedure which, if properly implemented, could largely obviate many of the discussed difficulties and problems.

I. Situations Requiring Valuation

Carrying out a stock purchase agreement, redeeming a dissenter's stock under an appraisal statute, and determining estate taxes due are three common instances in which valuation of shares in a closely held corporation is always necessary.

A. Stock Purchase Agreements

Shareholders of a closely held corporation often contract to sell their shares in the corporation to the remaining shareholders or to the corporation upon the occurrence of a specified event.[4] These stock purchase agreements usually take one of two forms: stock redemption, or cross purchase. In a stock redemption agreement, the corporation itself purchases the shares while in a cross purchase agreement the remaining shareholders purchase the stock.[5] The purchase and sale of the stock may be mandatory or optional. In an optional agreement, the corporation or the remaining shareholders have the "first option" to purchase the shares of the withdrawing shareholder.[6]

Regardless of the form of the stock purchase agreement, its purpose

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[4] Some of the more common events which are covered in stock purchase agreements are the death of a shareholder, disability of a shareholder, severence of employment with the corporation, the shareholder becoming bankrupt or insolvent, or the shareholder acquiring an interest in a competing company. *E.g.*, 2 F. O'Neal, *supra* note 3, at § 7.05.

[5] Though they will not be discussed in this comment, both forms have advantages and disadvantages, especially in the tax area, which should be considered. *See* Comment, *Stock-Purchase Transactions Upon the Death of a Shareholder of a Closely Held Corporation*, 45 Miss. L.J. 1191, 1192-95 (1974).

[6] A mandatory stock purchase agreement has a significant advantage over an optional one in that the purchase price agreed upon by the parties to the transaction will be accepted by the Internal Revenue Service for estate tax purposes. The agreement must contain mandatory buy-sell provisions activated upon the shareholder's death; establish a bona fide, arm's-length transaction; and contain inter vivos restrictions on transfer to be accepted by the Internal Revenue Service. A. Hull, Stock Purchase Agreements In Estate Planning-With Forms 41-44 (1969). Case law supports this conclusion even though the Internal Revenue Service, Treas. Reg. § 20.2031-2(h)(1974), refuses to concede that such an agreement will establish the estate tax value of the shares. *Id.* at 42. *See also* Comment, *supra* note 5.

is to aid in ensuring compatible, competent associates,[7] protecting subchapter S status,[8] and retaining management and control of the business within the same group or family.[9]

For a deceased shareholder's estate, the benefit of entering into an agreement for the sale of the shares can be significant. Since stock in a closely held corporation is often the primary asset in the shareholder's estate, lack of liquidity can be a major problem in meeting certain obligations of the estate.[10] There is, by definition, rarely an available market for the shares nor do they often generate significant dividend income.[11] Consequently, the estate may be unable to pay administrative expenses and estate taxes. The sale of the shares through the use of a mandatory stock purchase agreement could provide the estate with the liquidity necessary to satisfy these obligations.

Although the purchase price of the shares is usually established in a stock purchase agreement, faulty drafting can often cause the valuation issue to be presented to the courts.[12] The price determined by the court has a meaningful effect on items important to both parties to the sale. For the purchaser, a primary problem is the funding of the purchase price. Regardless of how the funding is accomplished,[13] the value

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[7] This reason is especially important if the corporation is a professional association. MISS. CODE ANN. § 79-9-15 (1972) provides that a professional corporation's shareholders must be legally authorized to render the same type of professional service as those for which the business was incorporated.

[8] INT. REV. CODE OF 1954, §§ 1371-77 provides for subchapter S treatment which allows closely held corporations to enjoy certain tax benefits accorded partnerships without losing the advantages of corporate organization. INT. REV. CODE OF 1954, § 1372(e)(1) provides that all shareholders must consent to a subchapter S election or the election will be terminated. The election may also be terminated if the shares pass to a partnership, trust, or another corporation since only individuals and estates may be shareholders. *Id.* at § 1371(a)(2). Termination of subchapter S status may result in severe tax penalties. Treas. Reg. § 1.1375-4(a) (1974).

[9] Beyond retaining control of the corporation within the existing shareholders, a stock purchase agreement also prevents a competitor from obtaining a majority of the stock. *See generally* 2 F. O'NEAL, *supra* note 3, at § 7.05.

[10] A. HULL, *supra* note 6, at 23.

[11] Nassau, *Buy-Out Agreements in Planning the Estate of a Shareholder-Employee of a Closely Held Corporation*, N.Y.U. 31ST INST. ON FED. TAX. 1029, 1030-31 (1973).

[12] *See, e.g.*, Empire Trust Co. v. Kurras, 226 App. Div. 554, 235 N.Y.S. 410 (Sup. Ct. 1929); Bendalin v. Delgado, 397 S.W.2d 884 (Tex. Civ. App. 1965), *rev'd on other grounds*, 406 S.W.2d 897 (Tex. 1966).

[13] Purchase of the stock may be funded by cash, property, debt instruments, installment sales, or some combination of these methods. The estate will probably have a need for cash to pay administrative expenses and estate taxes, but neither the corporation nor the remaining shareholders is likely to have sufficient cash resources to purchase the stock. Consequently, most agreements are funded, at least in part, by life insurance. 7 Z. CAVITCH, BUSINESS ORGANIZATIONS § 148.03 (rev. ed. 1974). For a discussion of the advantages and disadvantages of the various methods of funding a stock purchase agreement, see Comment, *supra* note 5, at 1216-32.

placed on the stock may determine the corporation's or the remaining shareholders' ability to purchase the stock. A higher than expected valuation may make the purchase impossible due to lack of sufficient funds. The value of the shares also determines qualification of the purchase as a redemption under section 303 of the Internal Revenue Code, which is of primary importance to the decedent's estate when the shares are purchased by the corporation.[14]

B. Appraisal Statutes

Under the common law, unanimous shareholder consent was required for fundamental changes in the corporation. This requirement, which afforded the minority shareholders a veto power, made large public corporations and development of the economy impossible. As a result, statutes compelling dissenting shareholders to submit to changes which the controlling majority proposed were enacted.[15]

The Mississippi Business Corporation Law[16] requires the consent of two-thirds of the shareholders for any plan of merger or consolidation[17] or any sale of all or substantially all of the assets of the corporation.[18] To prevent a dissenting shareholder from being forced to go along with unwanted change, the corporation is required, on demand, to pay any shareholder who promptly objects to the proposed action the fair value of his shares.[19] If the corporation's offer of the fair value of the stock is

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[14] INT. REV. CODE OF 1954, § 303 was created to provide relief for estates in which the primary asset is stock in a closely held corporation. This section provides that proceeds from the redemption shall be taxed at capital gain rates rather than as a dividend if certain requirements are met. The stock must be included in the estate, and the value of the stock must exceed either 35 percent of the gross estate or 50 percent of the taxable estate. This favorable tax treatment is limited, however, to the amount of estate taxes and funeral and administrative expenses incurred.

Note that this section applies only to corporate purchases. Purchases by surviving shareholders are considered sales of capital assets, and therefore, capital gain rates are applicable to the sale. *See generally* Nassau, *supra* note 11, at 1038.

[15] *E.g.*, Note, *supra* note 2; Note, *Corporation Law—Dissenting Stockholder's Right of Appraisal—Determination of Value*, 28 N.Y.U.L. REV. 1021 (1953); Note, *Appraisal of Corporate Dissenter's Shares: Apportioning the Proceedings Financial Burden*, 60 YALE L.J. 337, 338 (1951).

[16] MISS. CODE ANN. §§ 79-3-1 to -293 (1972).

[17] *Id.* § 79-3-145.

[18] *Id.* § 79-3-157 requires such approval if the assets are sold other than in the normal course of business. No shareholder consent is required if the sale is in the regular course of business. *Id.* § 79-3-155.

[19] *Id.* § 79-3-161. In order to receive the fair value of his shares, the shareholder must not vote in favor of the proposed action. Moreover, he must submit a written objection to the action prior to the shareholder vote and, within 10 days after the action is approved, make a written demand for payment. *Id.*

accepted by the dissenting shareholder,[20] judicial action is unnecessary. The statute, however, provides a remedy for those cases in which agreement cannot be reached by allowing the corporation to petition the chancery court of the county where the registered office of the corporation is located to determine a value for the shares.[21] The court is given no statutory guidance as to the relevant factors to be considered in ascertaining the fair value of the stock except that any appreciation or depreciation in anticipation of the proposed action must be excluded.[22]

C. Estate Tax

The process of determining a value for closely held stock for estate tax purposes usually involves considerable negotiation between the Internal Revenue Service and the decedent's estate, and the courts are often presented with the problem of settling disputes when the taxpayer refuses to accept the Service's valuation.[23] The value determined by the court is particularly important to the estate since it may be forced to sell some or even all of the stock just to pay the tax assessed.

The Mississippi estate tax law requires that the value of a resident's property located within the state, to the extent of his interest at the time of his death, be included in his estate.[24] The law specifically provides that the gross estate is composed of all property which the decedent owns at death whether it is real or personal, tangible or intangible.[25] Therefore, intangible personal items, including shares in a closely held corporation, are a part of the decedent's estate.[26] While the estate tax law states that the value of the property on the applicable valuation date is to be taxed,[27] the instructions for filing the estate tax return are written in terms of fair market value.[28] This term is neither officially defined by the law nor by the filing instructions, but the valuation included in the federal estate tax return is accepted as prima facie correct by the state tax commission.[29]

All property, whether real or personal, tangible or intangible, must

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[20] The corporation is required to make a written offer, accompanied by the latest balance sheet of the corporation, within 10 days after the action is complete. *Id.*

[21] *Id.*

[22] *Id.*

[23] For a discussion of this process see B. BITTKER, FEDERAL INCOME ESTATE AND GIFT TAXATION 893-907 (3d ed. 1964).

[24] MISS. CODE ANN. § 27-9-7 (1972).

[25] *Id.*

[26] Milam, *Estate Planning and Mississippi's Estate Tax*, 46 MISS. L.J. 27, 29 (1975).

[27] MISS. CODE ANN. § 27-9-7 (1972).

[28] *See* MISSISSIPPI STATE TAX COMM'N ESTATE TAX LAW, FILING INSTRUCTIONS 2-3 (1975).

[29] MISS. CODE ANN. § 27-9-29 (1972).

also be included in the decedent's estate for federal estate tax purposes.[30] Treasury regulations state that the fair market value of the property is to be taxed.[31] Fair market value is defined by the regulations as

> the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[32]

This definition is, of course, extremely difficult to apply to shares of stock in a closely held corporation. In an attempt to provide some basis for its application the Internal Revenue Code authorizes valuation by comparison of the closely held shares with the selling price of stock of companies listed on an exchange which are engaged in the same or a similar business and by consideration of "all other factors."[33]

II. Revenue Ruling 59-60

The valuation of closely held shares is necessary primarily in conjunction with a transfer of shares as discussed in the preceding section. The transfers of shares, in which valuation is necessary, are usually of a taxable nature. Transfers pursuant to a stock purchase agreement and purchases of stock from dissenting shareholders according to appraisal statutes result in tax liability for any gain recognized on the sale.[34] A gift of shares imposes gift tax liability on the donor based on the fair market value of the shares.[35] Most importantly, the fair market value of closely held shares is included in the decedent's gross estate for estate tax purposes.[36] Because of such considerations, the Internal Revenue Service's interest in the proper valuation of closely held shares is easily understood and well justified.

In light of this interest, the Internal Revenue Service promulgated Revenue Ruling 59-60 expressly "to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations for estate tax[37] and gift tax[38]

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[30] Int. Rev. Code of 1954, § 2031.

[31] Treas. Reg. § 2031-2(b), T.D. 7327, 1974-2 Cum. Bull. 295.

[32] *Id.* § 2031-1(b), T.D. 6826, 1965-2 Cum. Bull. 368.

[33] Int. Rev. Code of 1954, § 2031(b). Treasury regulations and certain revenue rulings expand on the other factors to be considered in the valuation of closely held stock. See text accompanying notes 37 through 43 *infra*.

[34] *See, e.g.*, Int. Rev. Code of 1954, §§ 1001-02.

[35] *Id.* §§ 2501(a), 2512(a).

[36] *Id.* §§ 2001, 2031(a).

[37] Rev. Rul. 59-60, 1959-1 Cum. Bull. 237, is directed toward a determination of fair market value as found in Int. Rev. Code of 1954, §§ 2031(a), 2032 and as defined in Treas. Reg. § 20.2031-1(b), T.D. 6826, 1965-2 Cum. Bull. 368, for estate tax purposes.

purposes."[39] Acknowledging that "no general formula" conforms to the variety of valuation situations which may arise, the Ruling states that the methods are applicable in other valuation situations.[40] Accordingly, the Ruling could be interpreted to govern both stock purchase agreements and appraisal transfers.

Eight factors listed for consideration are:

> (a) The nature of the business and the history of the enterprise from its inception.
> (b) The economic outlook in general and the condition and outlook of the specific industry in particular.
> (c) The book value of the stock and the financial condition of the business.
> (d) The earning capacity of the company.
> (e) The dividend-paying capacity.
> (f) Whether or not the enterprise has goodwill or other intangible value.
> (g) Sales of stock and the size of the block of stock to be valued.
> (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.[41]

The Ruling provides a helpful, general discussion of these factors. The list, however, by self-admission, is not inclusive.[42] Moreover, the Ruling does not provide a means for the application of the factors to the actual valuation situation, and, although it warns against using a weighted average of factors, the Service devises no method by which to integrate all the relevant factors into a final valuation.[43]

Thus, Revenue Ruling 59-60, in providing the official Service guidelines for valuation of closely held shares, is useful only as a starting point for valuation. This limited use, however, is important in that these guidelines can be readily extended and expanded into a meaningful framework for rational valuation analysis.

III. Valuation Factors

A necessary prerequisite to the formulation of a valuation method is a careful investigation of the factors which may affect the corpora-

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[38] For gift tax purposes, Rev. Rul. 59-60, 1959-1 Cum. Bull. 237, is directed to Int. Rev. Code of 1954, § 2512 (a) and Treas. Reg. § 25.2512-1, T.D. 6826, 1965-2 Cum. Bull. 369.

[39] Rev. Rul. 59-60, 1959-1 Cum. Bull. 237.

[40] *Id.*

[41] *Id.* at 238-39. For an explanation of the factors found in Rev. Rul. 59-60 see Olson, *Valuation of a Closely Held Corporation*, 128 J. Accy. 35, 38-39 (Aug. 1969).

[42] Rev. Rul. 59-60, 1959-1 Cum. Bull. 237.

[43] *Id.* at 243.

tion's value. This investigation provides a logical basis for deciding which factors are relevant so as to result in an accurate representation of corporate worth in the valuation formula. A study of these factors is also useful in determining which should be considered independently and which should be considered in conjunction with other factors in reaching values that are accurately representative. These values, properly adjusted, are the primary inputs for the final valuation of the corporation. The following factors, though not necessarily the only ones which could be considered, fairly represent the possible means for valuing closely held shares.

A. Net Asset Value

Net asset value[44] is calculated by first adjusting the balance sheet accounts as of the valuation date to reflect the actual economic value of the assets and the genuine liabilities of the business. The second step is to deduct the adjusted liabilities from the adjusted assets; the result of which is net asset value. The physicial asset adjustments are necessary because the assets are listed by their historical costs in accordance with generally accepted accounting principles which give an inaccurate picture of their true worth. Adjustments for variations in accounting methods and rising replacement costs are, for example, necessary to reflect the "going concern" value of the assets as they function within the business.[45] The going concern value is most accurately calculated by determining the total reproduction costs of the individual assets reduced by adequate depreciation to reflect age and obsolescence. This total should probably be increased by a percentage to reflect the added value of the unification of the individual assets into a complete business operation.[46]

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[44] In accounting terms, net assets are usually considered to be the excess of total assets over total liabilities as they appear on the corporation's books. Normally, no adjustment is made for valuation updating of the assets and liabilities. *See* H. BLACK, J. CHAMPION & R. BROWN, ACCOUNTING IN BUSINESS DECISIONS 58 (2d ed. 1967).

[45] Vass, *Factors that are Presently Being Emphasized in Valuing a Closely-Held Corporation*, 38 J. TAX. 356 (1973). For an exhibit of an adjusted balance sheet of a hypothetical close corporation see Olson, *supra* note 41, at 43.

[46] Lawinger, *Appraising Closely-Held Stock—Valuation Methods and Concepts*, 110 TRUSTS AND ESTATES 816, 872 (1971); Note, *supra* note 2, at 1457.

A going concern valuation may be inappropriate where a liquidation is imminent as, for example, in bankruptcy. In such a case the net asset value of the business should be based on liquidation value rather than reproduction costs because the shareholders can expect to realize only the sale value of the net assets on their investments. Hartwig, *Valuing an Interest in a Closely-Held Business for the Purpose of Buy/Sell Agreements and for Death Tax Purposes*, S. CAL. 26TH INST. ON FED. TAX. 215, 249 (1974); Note, *supra* at 1457.

Since intangible assets are comprised primarily of goodwill, which is really an earnings factor, they should not be considered in a net asset valuation. If the intangible assets are to be included, however, adjustments similar to those required for the physical assets must be made so that their value is accurately represented. The liabilities must also be examined and adjusted before being deducted from the assets to reach net asset value.

1. Physical Assets

The adjustments to the physical assets should be the result of an in-depth appraisal by an expert skilled in valuation methods.[47] One reason that it is important to employ an expert is that he may later have to testify concerning the valuation of the close corporation. Therefore, the expert needs to have adequate technical knowledge to be able to persuade the court that the valuation is accurate.[48]

Generally accepted accounting methods are not designed to maintain the assets on the books at their going concern value but rather at their historical costs. Accounting standards also permit several acceptable methods[49] which cause the balance sheet to reflect different values for the same assets according to the methods used. For example, accelerated depreciation, which allows the corporation to depreciate a large percentage of depreciable assets in the early years of the asset's life, usually results in the undervaluation of the depreciable assets on the books. Adjustments should be made to show the actual economic value according to the properly depreciated current replacement costs of the assets.[50]

Accounting for inventories may also present problems which require balance sheet adjustments. The inventory method used is usually determined in accordance with the type of business involved. Three basic methods are employed: LIFO (Last-in-first-out);[51] FIFO (First-in-first-

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[47] Lawinger, *supra* note 46, at 872.

[48] *See, e.g.*, Jenkins v. Young, 319 So. 2d 228 (Miss. 1975).

[49] Several depreciation methods are acceptable in accounting for long term assets. Straight-line, production, uniform-rate-on-a-declining balance, and sum-of-the-years-digits are four methods which are often used. Each of these methods produce a different asset value on the books. *See* H. Black, J. Champion & R. Brown, *supra* note 44, at 505-18.

There are also several widely used methods of valuing inventories. Specific-identification; first-in, first-out (FIFO); last-in, first-out (LIFO); and weighted average are the methods which are most prevalent. Like the depreciation methods, each inventory valuation method results in a different value. *Id.* at 449-61.

[50] Tierney, *A New Approach to the Valuation of Common Stock of Closely Held Companies*, 17 J. Tax 14, 16-17 (July 1962).

[51] "A method of inventory valuation in which most recent costs are assigned to the

out);[52] and the average cost[53] method. During the current inflationary period the LIFO method tends to understate the inventory accounts because the recently purchased, higher priced items are charged against the inventory accounts as sales are made while the older, lower priced inventory items remain in the inventory account. On the other hand, the FIFO method more accurately reflects the current replacement value of the inventory accounts by charging the older, lower priced items against inventory as sales are made and leaving the most recently purchased items in the inventory accounts. The averaging method provides that the costs of the inventories for an entire accounting period are divided by the number of units purchased, resulting in an average cost per item of inventory. This method is more accurate than LIFO but less accurate than FIFO in reflecting the reproduction cost of the inventory on hand during inflationary periods and may require an adjustment to the inventory account.[54]

Fixed assets, particularly real estate holdings, may require balance sheet adjustment since they often have appreciated substantially from the value at which they are carried on the books. One method of valuing real estate is the capitalization of a reasonable rental income from the property.[55] The capitalization method, however, integrates the earning power of the real estate into its value as an asset. Therefore, the reproduction cost method is preferable to the capitalization method because it is a pure asset valuation without regard to the earning potential of the real estate.[56] The earning potential of the real estate should be included in the earnings valuation of the corporation.[57]

The assets herein mentioned do not comprise a comprehensive list of the physical assets that may have to be adjusted but only point out special types of problems which may arise. To obtain an accurate repre-

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goods sold or used." J. ANDERSON & R. LENTILHON, PRINCIPLES OF ACCOUNTING 580 (1965). For a detailed explanation of how the LIFO method operates, see H. BLACK, J. CHAMPION & R. Brown, *supra* note 44, at 456-58.

[52] "[A] method of inventory valuation in which items first received [oldest] are assumed to have been the first sold or used in a period." J. ANDERSON & R. LENTILHON, *supra* note 51, at 579. For a more detailed explanation of the FIFO method see H. BLACK, J. CHAMPION & R. BROWN, *supra* note 44, at 455-56.

[53] For an explanation of the average cost method (also known as weighted-average method), see H. BLACK, J. CHAMPION & R. BROWN, *supra* note 44, at 458-60.

[54] Hardy, *Valuation—A Financial Planning Tool for Closely Held Corporations*, 113 TRUSTS AND ESTATES 584, 586 (1974).

[55] Williams, *Valuation of Closely-Held Corporations*, 110 TRUST AND ESTATES 184, 186 (1971).

[56] Note, *supra* note 2, at 1459.

[57] *See generally* notes 64 through 68 and accompany text *infra*.

sentation of the physical asset values, all the corporate assets must be physically appraised and properly adjusted.[58]

2. Intangible Assets

Intangible assets are usually represented on the balance sheet by "goodwill." Often a goodwill account has not been placed on the balance sheet prior to the litigation and the court must determine its value. Goodwill may represent various assets such as "copyrights, trademarks, market acceptance, secret processes and formulas . . . franchise rights, license agreements, noncompetition agreements, employment contracts, purchase contracts"[59] and other intangible characteristics which enable the particular corporation to make a better than normal profit. Furthermore, there may be other valuable intangible assets which the corporation has written off as expenses, such as "leases, patents, franchises, relocation costs, start-up costs and major expenditures for market research and promotion"[60] which may warrant an adjustment to the corporation's balance sheet.

The valuation of intangible assets for which no cash outlay has been made is particularly difficult because, unlike physical assets, there are no reproduction costs available to determine their value. Capitalization is a possible method of valuation but, as with real estate, the capitalization of intangibles integrates their earning potential into a valuation which is supposed to reflect only the balance sheet value of the assets. Since goodwill represents intangible characteristics which enable a corporation to earn a larger than normal profit, it is by definition an earning factor and probably should not be considered unless net asset valuation is the only method used in the ultimate valuation of the corporation. Where a combination of net asset value and earnings value is used, goodwill will be accounted for in the earnings value calculation.[61]

3. Liabilities

Adjustments for liabilities can involve more than a mere analysis of the balance sheet since the balance sheet may not always reveal

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[58] For a comprehensive list of physical assets that may need to be valued see Lawinger, *supra* note 46, at 873-74.

[59] Hartwig, *supra* note 46, at 251. *But see* Donaldson, *Goodwill and Other Intangibles in Business Acquisitions*, N.Y.U. 31ST INST. ON FED. TAX. 291, 296-98 (1973).

[60] Hartwig, *supra* note 46, at 250; *see* Lawinger, *supra* note 46, at 872.

[61] Capitalization through the "formula" approach is the method which the Internal Revenue Service suggests unless "there is better evidence from which the value of the intangibles can be determined." Rev. Rul. 68-609, 1968-2 CUM. BULL. 327, 328, superceding A.R.M. 34, 2 CUM. BULL. 31 (1920); A.R.M. 68, 3 CUM. BULL. 43 (1920); Rev. Rul. 65-192, 1965-2 CUM. BULL. 259. *See* Hartwig, *supra* note 46, at 253; Olson, *supra* note 41, at 37.

liabilities which could have an adverse effect on business operations. Even though they are not clearly disclosed, such hidden liabilities as pending lawsuits or financially unfavorable binding business agreements must be considered in a determination of net asset value.[62]

Conversely, the liabilities may be overstated where a contingent liability, such as a pending lawsuit which was settled for less than the anticipated cost or an estimated tax which was less than expected, is still on the balance sheet.

Identification of all relevant factors requiring balance sheet adjustment obviously entails a detailed and expensive appraisal of the corporation. In each valuation case, the extent of the appraisal's development will largely depend upon a weighing of the appraisal's expense against the expected beneficial results.[63]

B. Earnings Value

Earnings value has been treated by the courts as being one of the most important factors in determining the value of closely held corporations.[64] Capitalization of earnings, the method primarily used for calculating earnings value, requires the multiplication of the "normal earnings" of the corporation by a capitalization rate (multiplier) which reflects the stability of the past and the predictability of the future corporate earnings.[65] An analysis of past years' profit and loss statements is necessary for the determination of the corporation's normal earnings. It is usually preferable to establish an average of at least the 5 most recent years; however, 5 years is an arbitrary figure and the courts may use a different number depending upon the situation.[66]

Adjustments to the profit and loss statements are necessary to calculate the normal earnings of the corporation for past years. For example, nonrecurring items, such as extraordinary losses caused by natural disasters or extraordinary profits resulting from war years when demand was much higher than normal, should be eliminated. Also, in close corporations the majority shareholders may be paying themselves excessive salaries as officers of the corporation or a shareholder may be renting buildings, real estate, or equipment to the corporation at excessive

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[62] *See* Hartwig, *supra* note 46, at 250-51. *But see* Hardy, *supra* note 54, at 586-87; Cohan, *Valuation of Interests in Closely Held Businesses*, 44 TAXES 504, 508 (1966).

[63] Cohan, *supra* note 62, at 508; Vass, *supra* note 45, at 356; *see* Tierney, *supra* note 50, at 15; Williams, *supra* note 55, at 184.

[64] *See, e.g.*, Central Trust Co. v. United States, 305 F.2d 393, 432 (1962); Brown v. Hedahl's-Q.B. & R., Inc., 185 N.W.2d 249 (N.D. 1971).

[65] Hartwig, *supra* note 46, at 256-64; Vass, *supra* note 45, at 357.

[66] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 240; Note, *supra* note 2, at 1464-65; *see, e.g., In re* Northwest Greyhound Lines, Inc., 41 Wash. 2d 672, 251 P.2d 607 (1952).

rates. On the other hand, a shareholder may be serving as an officer for a much lower salary than that of the same officer in a comparable corporation or the corporation may be renting assets at less than their fair rental value. As with the net asset valuation, accounting methods may cause misrepresentation of the corporate profit or income. Both accelerated depreciation and the LIFO inventory method tend to cause net income to be understated.[67] All of these abnormalities require adjustments to the profit and loss statements.[68]

Once adjustments to the profit and loss statements are made, an average normal earnings figure can be calculated. Average normal earnings is the figure which is capitalized by the capitalization rate (multiplier), the product being the earnings value. Therefore, the next step in the capitalization process, which is also the most difficult, is the determination of a multiplier. The multiplier integrates into a single figure all the factors which represent the future earnings potential of the corporation.[69] Since future earnings are of a highly speculative nature, this determination must be inexact. The unpredictability of future earnings also makes more sophisticated techniques of calculating earnings value, such as split capitalization[70] or the discounting of weighted predicted future earnings, of questionable value. Instead, all relevant factors should be considered and incorporated into a reasonable single multiplier.[71]

This method simplifies matters for both the courts and the appraiser by providing for consideration of all relevant factors without overly complicating an already highly speculative process. Dewing's method of determining a multiplier, which lists seven categories of businesses with corresponding multipliers, is an often-used guideline.[72] Dew-

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[67] For an excellent exhibit of the effect that differing accounting methods can have on net income see Tierney, *supra* note 50, at 16-17.

[68] Cohan, *supra* note 62, at 508; Hardy, *supra* note 54, at 587. For an exhibit of the adjusted income statements of a hypothetical close corporation see Olson, *supra* note 45, at 44.

[69] For a list of factors to consider in determining a multiplier see Vass, *supra* note 45, at 357.

[70] See note 78 and accompanying text *infra*.

[71] Note, *supra* note 2, at 1467. *But see* Banks, *supra* note 1, at 33 (discounting to present value); Cohan, *supra* note 62, at 508-09 (split capitalization of tangibles and intangibles); Hardy, *supra* note 54, at 623-25 (discounting weighted predicted future earnings to present value); Hartwig, *supra* note 46, at 261-64 (assigning weights according to probability of predicted future earnings and discounting to present value).

[72] A. Dewing, The Financial Policy of Corporations 390-91 (5th ed. 1953). Dewing's categorization of businesses is as follows:

> 1. Old established businesses, with large capital assets and excellent goodwill—10%, a value ten times the net earnings . . . .
> 2. Businesses, well established but requiring considerable managerial care . . . . 12-½%, a value eight times the net earnings.

ing's method, however, is too limited in some cases because it provides an upper limit of ten for a multiplier and does not provide for consideration of the full range of factors which should affect the choice of a multiplier. Despite its limitations, the method does provide helpful guidelines.[73]

Once the relevant range for a multiplier has been chosen, refinement of the capitlization rate can be accomplished through a consideration of the following factors.

1. Trends

An earnings trend, if one exists, should be determined by analysis of past years' normal earnings.[74] The importance of the earnings trend cannot be overemphasized.[75] Since the capitalization calculation is designed to value a stream of future earnings, a consistent trend should be incorporated into a multiplier so that the general direction of the business can be more accurately predicted.

For example, suppose the annual normal earnings for 5 consecutive years beginning with 1970 were $50,000; $75,000; $100,000; $125,000; and $150,000 for Corporation *A* but were reversed and were $150,000; $125,000; $100,000; $75,000; and $50,000 for Corporation *B*. The average annual earnings for both Corporations *A* and *B* is $100,000 for the years 1970-74. This figure is obviously deceptive since Corporation *A*'s income is steadily rising while Corporation *B*'s income is decreasing. Therefore,

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3. Businesses, well established, but involving possible loss in consequence of shifts of general economic conditions. They are strong, well established businesses, but they produce a type of commodity which makes them vulnerable to depressions . . . . 15%, a value approximately seven times net earnings.
4. Businesses requiring average executive ability—and at the same time comparatively small capital investment. These businesses are highly competitive, but established goodwill is of distinct importance . . . . 20%, a value approximately five times the net earnings.
5. Small industrial businesses, highly competitive, and requiring a relatively small capital outlay . . . . 25%, a value approximately four times net earnings.
6. Industrial businesses, large and small, which depend on the special, often unusual skill of one, or of a small group of managers. They involve only a small amount of capital; they are highly competitive and the mortality rate is high . . . 50%, a value of approximately twice net earnings.
7. Personal service businesses. They require no capital . . . . The manager must have a special skill coupled with an intensive and thorough knowledge of his subjects . . . . 100%, a value equal, approximately, to the earnings of a single year.

[73] Banks, *supra* note 1, at 43; *see* Vass, *supra* note 45, at 357.

[74] Sophisticated quantitative techniques (least squares method) have been developed for determining trend consistency. Hardy, *supra* note 54, at 623.

[75] *Cf.* Note, *supra* note 2, at 1465.

Corporation *A* should have a higher multiplier than Corporation *B* based on *A*'s apparently favorable earnings position, all other factors being equal.[76]

2. Goodwill

> A folksy definition of good will is people's habit of patronizing a particular establishment resulting in unusually high profits. More precisely, good will represents the excess of a business' earning power over a fair return on the value of its net tangible assets (the gross fair market value of its assets less liabilities).[77]

Goodwill, therefore, is a factor which inherently participates within the earning function of the business.

Split capitalization, which operates to apply one capitalization rate to the earnings represented by a fair rate of return on the physical assets and another rate to the excess of earnings represented by goodwill, is often advocated so that goodwill's presence will be acknowledged.[78] However, since the proportion of earnings represented by goodwill and those represented by the physical assets are indistinguishable, the split capitalization method does not seem to facilitate the accuracy of the speculative capitalization computation.[79] Nevertheless, the value of the intangible assets representing goodwill is an important factor and should be given careful consideration in the determination of a single capitalization rate.[80]

3. Management Stability

The efficient functioning of the business operations in close corporations is often largely dependent upon the experience and technical knowledge of a few key employees. The status of these employees with regard to age, dependency of the business upon the persons' services, and the probability of replacement of key employees by persons with comparable skill and knowledge should be considered.[81]

The death of a key employee may even have been the reason for the share transfer which necessitated the valuation. A key person's death

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[76] *See* Hardy, *supra* note 54, at 623-24.

[77] Cohan, *supra* note 62, at 508.

[78] *Id.*; Williams, *supra* note 55, at 187; *see* Rev. Rul. 68-609, 1968-2 CUM. BULL. 327; Hartwig, *supra* note 46, at 250.

[79] Hartwig, *supra* note 46, at 253-54; Note, *supra* note 2, at 1466; *see* O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773, 804-05 (1952).

[80] *See generally* Donaldson, *supra* note 59.

[81] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 239; Tierney, *supra* note 50, at 14; *see* Vass, *supra* note 45, at 357.

should serve to increase the applicable capitalization rate, thereby decreasing the earnings multiplier, if the efficient operation of the business would be adversely affected or the death results in a substantial loss of business goodwill.[82] If a key person's death would put the future operation of the business into question, it may be necessary to consider management stability as an independent discount factor to be applied to the final valuation rather than in the determination of a multiplier.[83]

4. Other Factors

The economic forecast generally and within the industry may portend significant changes in future earnings. Economic indicators should reflect the national outlook while industry outlook may be indicated by the trends within the industry as compared with general economic trends. A comparison of the close corporation with other businesses within the industry by means of financial ratios is particularly useful in determining the status of the close corporation within the industry.[84]

The nature of the enterprise may have an important effect on its value. For example, if the corporation produces a highly specialized product and there is some danger that its use will be discontinued in the future, the risk involved in the business operation is increased and the earnings multiplier should be decreased.[85] Finally, a historical analysis of the business should be made to reveal the durability of the enterprise, the stability of its past earnings, the corporation's expansion rate, and other factors necessary to evaluate the predictability of future earnings. If available, the financial statements dating back to the commencement of the corporate activities are valuable for the historical investigation.[86]

C. Dividend Payments and Payment Capability

Although some courts persist in using the capitalization of dividends or dividend paying capacity as a measure of value for closely held

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[82] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 239; Lawinger, *supra* note 46, at 817. Note that an increase in the capitalization rate results in a decrease in the multiplier thereby reducing the projected value of the business. *See* note 72 *supra*.

[83] Williams, *supra* note 55, at 188.

[84] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 239; Korner, *Issues and Problems in Valuing Closely Held Business Interests for Estate Tax Purposes, Especially Partnership Interests*, N.Y.U. 30TH INST. ON FED. TAX. 185, 193-94 (1972). *See generally* Weed, *Techniques in Valuation of Close Corporations*, N.Y.U. 30TH INST. ON FED. TAX. 597, 599 (advocating use of comparative approach for all valuation factors).

[85] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 239.

[86] *Id.*; Olson, *supra* note 45, at 38.

corporations,[87] there are several reasons why dividends or the capacity to pay them should not be given more than minimal consideration. The primary reason is that dividend payments are a direct function of the earnings of the corporation. Therefore, the earnings represented by dividends would in reality be capitalized twice if a combination of earnings value and dividend payments were used in the final valuation. The dividend payments or payment capability thus should not be separately considered since they are accurately reflected by the earnings value calculation.[88]

There are two additional reasons why dividend capitalization may be deceptive as a valuation factor. First, even though the funds are legally available, a close corporation cannot ordinarily pay dividends at the same rate as a publicly held corporation. Cash must usually be retained for operating capital purposes because close corporations cannot obtain needed funds through debt securities or loans as readily as publicly held corporations. Therefore, the regular payment of dividends in a close corporation could be the exercise of bad business judgment rather than a favorable valuation factor, since dividend payments could deplete working capital below the level at which the corporation operates at optimum efficiency.[89] This dilemma could possibly be remedied by capitalizing the dividend paying capacity instead of the actual dividend payments, but the problem of double capitalization of earnings would still be present. Secondly, the majority shareholders, in order to avoid double corporate taxation of dividends, often draw money out of the corporation through salaries, rents, or interest rather than in the form of dividends.[90] This is not the usual practice in the case of a publicly held, actively traded corporation where there are no majority shareholders. Therefore, the dividend payments or dividend paying capacity of a close corporation may not be representative of its value in comparison with a publicly held corporation.[91]

D. Market Value

The market value of publicly held stock which is actively traded on an exchange may be ascertained by verification of the price at which the stock was being traded as of the valuation date. Ordinarily, the market

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[87] *E.g.*, Central Trust Co. v. United States, 305 F.2d 393 (Ct. Cl. 1962); *see* Righter v. United States, 439 F.2d 1204, 1210 (Ct. Cl. 1971).

[88] *See* Korner, *supra* note 84, at 192; Olson, *supra* note 41, at 38; *cf.* Note, *supra* note 2, at 1468.

[89] Note, *supra* note 2, at 1468.

[90] *See* Korner, *supra* note 84, at 191-92.

[91] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 241; *see* Hardy, *supra* note 54, at 623; Hartwig, *supra* note 46, at 254-56; Williams, *supra* note 55, at 187.

value of publicly traded stock should be given substantial weight in the determination of its fair market value.[92] The close corporation's stock, though, is normally not actively traded and, therefore, has no established market value.[93] Nevertheless, two methods have been devised by which a hypothetical market value for close corporation shares may be established.

The first method involves the multiplication of the price-earnings ratios of comparable actively traded corporations, which are listed on an exchange, by the earnings per share of the closely held corporation.[94] This "comparable company" approach is unreliable because it is extremely difficult to find sufficiently comparable companies.[95] Also, even if the companies' businesses were sufficiently comparable, close corporations possess characteristics which make them inherently different from publicly held corporations. Investors are generally familiar with the corporate name of actively traded, publicly held stock since it is regularly listed on an exchange. This familiarity may create unfounded investor confidence which, in turn, causes artificially high prices.[96] Furthermore, the price of publicly traded stock is enhanced by its marketability, whereas the lack of marketability of close corporation stock may substantially decrease its value.[97] Finally, any transfer of close corporation stock is likely to involve a substantial percentage of the voting shares. This potential transfer of shareholder control would have a significant effect on the value of the transferred shares. On the other hand, most exchanges of publicly held corporation stock affect only a small percentage of the total shares outstanding and usually have no effect on the voting control of the corporation.[98] These differences undermine the basic assumption of the comparable company approach: where a price-earnings ratio of a publicly held corporation is applied to a supposedly similar close corporation, it represents a valid determination of closely held corporate stock's market value.[99]

A second method of constructing a market value is through the use of bona fide, arm's-length stock transactions which took place within a

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[92] Note, *supra* note 2, at 1462-63.

[93] O'Neal, *supra* note 79, at 801.

[94] *Id.* at 801 n. 104. The *price-earnings ratio* is calculated by dividing the market value of the share by the earnings per share. For example, if the market value of the stock is $30 and the earnings per share is $3 the price earnings ratio is 10. Net income divided by shares outstanding yields *earnings per share* for any particular year. *See* D. CORBIN, ACCOUNTING AND ECONOMIC DECISIONS 444-45 (1968).

[95] Korner, *supra* note 84, at 194.

[96] *Id.*

[97] Tierney, *supra* note 50, at 16.

[98] *See* Cohan, *supra* note 62, at 506.

[99] Tierney, *supra* note 50, at 15-16.

reasonably short period either before or after the valuation date. One problem with this method is that transactions in close corporation stock are seldom of a bona fide, arm's-length nature, because close corporation stockholders are often related or have some affinity greater than a mere common business interest.[100] Also, the stock's market value may have been affected by events occurring between the valuation date and the date of the transaction in question.[101]

Lastly, a few isolated transactions, even if at arm's length, are not sufficient to establish a reliable market value simply because there are neither enough investors involved nor shares traded to make possible a financial evaluation of the stock.[102]

Based on these shortcomings, the construction of a hypothetical market value for use as a valuation factor is undesirable.[103] The comparable company approach, however, may be useful as a check to determine whether the earnings value calculated through the capitalization of earnings method is within a relevant range.[104] In using the comparable company approach as a check, the comparable company's price-earnings ratio should probably be discounted 10 to 15 percent to reflect factors such as lack of marketability which tend to lower the value of closely held shares.[105]

E. Discounts

The final step in a valuation of a closely held corporation is a determination of the possible deflating effects that the transfer of a minority interest, the lack of marketability that accompanies close corporation ownership, and any binding stock transfer restrictions could have on the fair market value of the transferred shares. These are independent factors which, because of their adverse effect on stock value, operate to discount the final valuation by a percentage amount.[106]

1. Minority Interest Discounts

In publicly held corporations there are often no majority shareholders. Therefore, no one shareholder or group of shareholders exercises control over the corporation. Instead, there is usually management con-

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[100] *See* Korner, *supra* note 84, at 192.

[101] *Id.*

[102] *See* Righter v. United States, 439 F.2d 1204, 1209 (Ct. Cl. 1971); Central Trust Co. v. United States, 305 F.2d 393, 402 (Ct. Cl. 1962).

[103] *Cf.* Cohan, *supra* note 62, at 506; Korner, *supra* note 84, at 193.

[104] Note, *supra* note 2, at 1463.

[105] *Id.*

[106] *See* Hartwig, *supra* note 46, at 265-68.

trol. In a close corporation, however, a majority shareholder usually does possess control of the corporation and, as a result, a minority shareholder is often in a rather helpless position.[107] This lack of control substantially reduces the minority shareholder's stock value because the per share liquidation value is the only assured value of minority shareholder ownership.[108] The reason is that majority shareholders of close corporations usually choose to receive corporate benefits in the form of salaries, rents, interest, or other corporate income. These benefits may be received in lieu of dividends to avoid double corporate taxation. The majority shareholder can effectively preclude the minority shareholder from receiving these benefits as well as any dividends by virtue of his controlling position in the corporation's voting shares.[109] The courts recognize that minority shareholders are often excluded from participating in the corporate advantages enjoyed by the majority shareholder and discount the stock value to reflect the minority shareholders' handicap.[110]

Before giving a minority discount, a careful evaluation should be made to determine whether the shareholder involved actually suffers from the lack of control caused by a minority ownership interest.[111] For example, if a controlling block of stock is owned within an intimate family group which acts together, a minority discount may not be warranted for transfers within the family. Adjustment is not necessary even though each family member owns a minority interest since the family, as a unit, controls the corporation for the family's mutual benefit.[112] On the other hand, where a controlling block of shares is being transferred an increase in the value may be warranted.[113] Although the courts have not generally recognized this, a controlling interest should be taken into account in lowering other discount factors such as lack of marketability.[114]

2. Lack of Marketability

In addition to the minority discount, the need for a discount to reflect the usual absence of a market in which to dispose of closely held

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[107] *See* Cohan, *supra* note 62, at 505.

[108] *See* Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares*, 122 U. PA. L. REV. 934, 935-36 (1974).

[109] *See* Lawinger, *supra* note 46, at 873.

[110] For a chronological listing of minority discount cases see Dant, *Courts Increasing Amount of Discount for a Minority Interest in a Business*, 43 J. TAX. 104, 106-08 (1975).

[111] Feld, *supra* note 108, at 937.

[112] *See, e.g.*, Richardson v. Commissioner, 2 T.C. 1039 (1943), *aff'd*, 151 F.2d 102 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946).

[113] Korner, *supra* note 84, at 196.

[114] Hartwig, *supra* note 46, at 267.

shares should be recognized.[115] The lack of marketability is especially apparent where a minority interest is involved because investors are generally aware of the disadvantages accompanying minority ownership in a closely held corporation.[116] Moreover, due to the inherent difference between investing in a close corporation as opposed to a publicly held corporation, even a controlling interest may be unmarketable. Because of the close corporation's relative smallness, ownership of closely held shares often entails active participation in the management and operation of the corporation as opposed to a passive ownership of shares in a large publicly held corporation. Obviously, it is more difficult to locate investors who want to become involved with management and operation functions than investors who simply hope to derive income from their investments. Finally, securities regulations contribute to the lack of marketability because closely held shares are usually distributed under exemptions to the Securities Act of 1933 which imposes restrictions on the sale of the stock according to time periods, dollar amounts, and geographical areas.[117]

Although there is no method of ascertaining an accurate percentage discount for lack of marketability, one method that will at least give consistent results is to discount the value of the stock by the percentage of the stock value that would be required to float the issue.[118] This method, however, has no rational basis other than to establish reliable guidelines. Registering the securities of a close corporation probably does not affect marketability to any appreciable extent unless the primary reason for the lack of marketability is securities regulation rather than close corporation characteristics. As a practical matter, this is not usually the case.

3. Stock Transfer Restrictions

Retention of ownership and control of the corporation within a confined group of owners is one of the primary purposes for the formation of a close corporation. In order to fulfill this purpose the shareholders often enter into agreements restricting the transferability of the stock.[119] Mandatory purchase agreements which provide that the corporation or shareholders must buy the stock of another owner upon the occurrence

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[115] *Id.* at 265.

[116] *See* Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 242; Lawinger, *supra* note 46, at 872-73.

[117] *See* Hartwig, *supra* note 46, at 266-67. *See generally* Comment, *Exemption from Registration Under the Securities Act of 1933 and Registration of Securities Under the Mississippi Securities Law*, 46 MISS. L.J. 975 (1975).

[118] Hartwig, *supra* note 46, at 265-66; Vass, *supra* note 45, at 358.

[119] Feld, *supra* note 108, at 946; *see* Korner, *supra* note 84, at 196-97.

of certain events, such as the death of an owner, are often used. Option agreements which give the corporation or shareholders first option to purchase the stock in the event that a shareholder decides to sell the stock also constitute a common method of restricting the transferability of closely held stock. The agreements may state a price or a method for arriving at a price which is binding on the parties.[120] Even if there is no fixed price, the restriction on the transferability of the stock may warrant a discount in the determination of the stock's value since the agreement may provide for sale at less than fair market value.[121]

IV. Judicial Interpretation

It is readily apparent from the foregoing discussion why the courts have often found the task of valuing shares of stock in a closely held corporation to be overwhelming. Considering all factors relevant to the valuation without becoming hopelessly confused is extremely difficult. One court has described the process of valuation as being "a matter of judgment and opinion" based on the facts of each case with the result being little more than an "educated guess."[122] Thus, it is understandable that the courts have managed to support the values arrived at with varying degrees of success.

Many courts have simply sorted through the various factors relevant to the case, professed to consider and weigh each factor, and then announced a value for the stock without any indication of which factors the court thought important.[123] This approach to the valuation of stock in a closely held corporation for estate tax purposes was evident in *Righter v. United States*.[124] The court, as usual, was confronted with a wide range of values for the shares, and it reviewed the value each expert witness proposed.[125] Refusing to accept the taxpayer's valuation, the court stated that it was based on a single isolated sale which was not an arm's-length transaction.[126] The witnesses for the Commissioner of

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[120] Feld, *supra* note 108, at 946-47.

[121] *Id.* at 947-48.

[122] South Carolina Nat'l Bank v. McLeod, 256 F. Supp. 913, 927-28 (D.S.C. 1966).

[123] "It is unwise to attempt to state every factor that may bear on value of stock in a particular case." Robbins v. Beatty, 246 Iowa 80, 91, 67 N.W.2d 12, 18 (1954). *See also* Baltimore Nat'l Bank v. United States, 136 F. Supp. 642 (D. Md. 1955).

[124] 439 F.2d 1204 (Ct. Cl. 1971).

[125] The proposed values ranged from a low of $424.90 per share, the value included on the estate tax return, to a high of $1000.00 per share, the value estimated by both of the expert witnesses for the Commissioner of Internal Revenue. *Id.* at 1206.

[126] *Id.* at 1209. The taxpayer attempted to provide additional support for its proposed value by showing that the Internal Revenue Service had accepted values for the corporation's stock ranging from $235 per share to $450 per share in estate tax returns filed prior to this case. The court, however, did not accept these figures as determinative of the value but rather as merely some evidence which might be considered. *Id.* at 1210-12.

Internal Revenue valued the stock by comparison with other companies in similar businesses. These values were also rejected since, in the court's view, the companies used in the valuation were not truly comparable with the company involved in *Righter*.[127] The court concluded that it must value the stock by "considering all the evidence and the whole record," and, without further explanation, the court stated its value for the stock.[128]

Other courts have placed primary or even total reliance on one or two factors,[129] but the best reasoned and supported court valuations have utilized a consideration of all relevant factors coupled with a careful weighing of each factor.[130] *Brown v. Hedahl's-Q.B.&R., Inc.*,[131] serves as an excellent example of this approach to valuation. The court was presented with the problem of valuing shares under an appraisal statute when shareholders dissented from a proposed merger. Although both parties offered expert testimony, the court rejected all of the proposed values due to inadequacies in the methods used.[132] The court held that the methods of net asset value, earnings value, and market value must be used in determining the fair market value of stock in a closely held corporation, and that all aspects of the company must be considered in assigning a percentage weight to the values determined under each method. The net asset value was ascertained by adjusting the book value for items such as the current value of real estate, buildings, and equipment; an allowance for the uncollectibility of accounts and notes receivable; and worthless securities held by the corporation. Earnings value was determined to be zero since the corporation had sustained losses for several years, and a market value was reconstructed from

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[127] *Id.* at 1217.

[128] *Id.* at 1219. The court's valuation of the stock at $700 per share prompted the dissent to remark, "I do not know how the court arrived at it, and the opinion does not explain." *Id.* at 1224.

[129] *E.g.*, Elverson Corp. v. Helvering, 122 F.2d 295 (2d Cir. 1941)(capitalization of earnings); Swartz v. United States, 182 F. Supp. 540 (D. Mass. 1960)(book value).

[130] This approach to valuation was developed by the Delaware courts which require the expert witness to state the weight he has assigned to each factor. For a discussion of Delaware cases adopting this approach see Note, *supra* note 2, at 1469-71.

[131] 185 N.W.2d 249 (N.D. 1971).

[132] The two witnesses for the shareholders valued the stock at $322 and $249 per share respectively. In the court's view, neither witness placed sufficient emphasis on the zero earnings value of the corporation, and one witness merely adopted the book value of the shares adjusted by a large provision for goodwill and a write-up of certain real estate to its fair market value. *Id.* at 254-55.

The witness for the corporation valued the stock at $100 per share. His valuation was based on net asset value, supported by no exact calculation, an earnings value of zero, and prior sales of the stock. This testimony was rejected apparently because the witness failed to explain his computation in sufficient detail. *Id.* at 255-56.

limited transactions that occurred during the previous 5 years.[133] The weight assigned to each value was then determined by considering items such as the degree to which the market for the stock was reliable, the purpose for which the assets were held, and the prospect of future earnings.[134] Although the resulting value was not without fault,[135] the court made a bona fide attempt to consider all relevant factors in valuing the stock.

The same approach to valuation was utilized for valuing shares of stock in a closely held corporation for gift tax purposes in *Central Trust Co. v. United States*.[136] In a lengthy opinion, the court reviewed the proposed values of the expert witnesses in exhaustive detail before concluding that none of the appraisals could be accepted.[137] The court stated that comparison with other companies should be used to value the shares and that earnings, dividend paying capacity, and book value were the important factors. The court then engaged in an extremely complex calculation of the value of each factor based on the value of the factors in five similar companies.[138] The valuation was completed by weighing each factor and applying a discount for marketability.[139] Al-

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[133] *Id.* at 257. There were only eight sales of the stock during this period. A market value based on limited transactions is generally not an accurate measure of value. See text accompanying note 102 *supra*.

[134] 185 N.W.2d at 259. A weight of 50 percent was assigned to the net asset value since the assets were held primarily to generate earnings rather than to appreciate in value in which case a greater weight would have been required. Both the market value and the earnings value were accorded a 25 percent weight since the court felt that the market was not reliable enough to be given a greater weight and that the improved management resulting from the merger would increase earnings. The court determined the value of the stock to be $138.65. *Id.*

[135] *See* text accompanying note 102 *supra*.

[136] 305 F.2d 393 (Ct. Cl. 1962). This decision has been cited with approval by several commentators. *E.g.*, Olson, *supra* note 41, at 36 n. 4; Vass, *supra* note 45, at 258.

[137] The values proposed by the taxpayer and his expert witnesses ranged from $7.50 to $11.76 per share. The $7.50 valuation was rejected since it was based on isolated sales of the stock (46 sales during a 4-year period). The three expert opinions provided by the taxpayer each considered the book value, the earnings value, the dividend paying capacity, prior sales, and lack of marketability to be the factors affecting the value of the stock. The court criticized the opinions for giving undue weight to the prior sales; for failing to consider the earnings trend of the company; for taking too great a discount for lack of marketability; for failing to make certain adjustments to the book value; for failing to eliminate nonrecurring items which affected earnings; and for failing to give adequate weight to earnings. 305 F.2d at 399-405.

The expert witness for the Internal Revenue Service valued the stock at $16.00 per share by utilizing a method which compared the company's stock with stock in companies in similar businesses. In the court's view, however, the companies used in the calculation were not truly comparable. *Id.* at 406-08.

[138] *Id.* at 408-32.

[139] *Id.* at 432. The earnings were given a weight of 50 percent; dividends 30 percent; and book value 20 percent. Note that earnings were in effect given an 80 percent weight

though the process of valuation utilized by the court in this case is entirely too complex, the decision represents the same type of thoroughness evinced in the *Brown* decision.

The Mississippi Supreme Court has been confronted with the task of valuing stock in closely held corporations on two occasions. In *Cal-Maine Foods, Inc. v. Duvic*,[140] the court, reviewing the chancellor's valuation of dissenting shareholders' shares under the appraisal statute, refused to grant a request that the price be redetermined. Appellant argued that the chancellor had not considered all factors affecting the value of the stock. The court responded that it was unable to say that the chancellor's valuation was not supported by the evidence or that he was manifestly wrong; therefore, the decree was affirmed.[141] The opinion made only a cursory review of the chancellor's determination and offered neither support nor even a listing of the factors considered.

In *Jenkins v. Young*,[142] the court may have performed a slightly more thorough review. The chancellor had established a value for closely held shares which were to pass from a testamentary trust under the will of the decedent. On appeal, the methods used by the expert witnesses were noted,[143] but without any comment on the validity of the methods, the court relied on *Cal-Maine Foods* to state that it could redetermine the shares' value only where the chancellor was manifestly wrong.[144] Once again, the decree was upheld without any real analysis of the accuracy of the value established by the chancellor.

V. Weighted Average Method

Upon a consideration of the valuation factors in section III and the judicial interpretations in section IV, it is apparent that various meth-

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since dividends are a function of earnings. *See* text accompanying notes 87 through 91 *supra*. The resulting valuation was $15.50 per share. 305 F.2d at 433.

[140] 264 So. 2d 383 (Miss. 1972).

[141] *Id.* at 384.

[142] 319 So. 2d 228 (Miss. 1975).

[143] The appellant had presented one witness who insisted that the value be determined by a comparison of sales of minority interests in similar closely held corporations. This witness was denied expert status by the chancellor since his experience was thought to be limited. One of the two expert witnesses for the appellee had used the capitalization of earnings method to value the stock while the other witness used a method which consisted of weighing nine factors: current earnings, a weighted average of audited net earnings for the last 5 years, unit sales, a weighted average of unit sales for the 5 years, cash flow, a weighted average of cash flow for the last 5 years, gross revenues, capital assets adjusted, and other considerations. *Id.* at 230-31. The court termed these other considerations as "things which did not lend themselves to a strict mathematical computation . . . ." *Id.* at 231. Of course, few of the factors relevant to a valuation of stock in a closely held corporation are susceptible to precise mathematical calculation.

[144] *Id.* at 231.

ods can be employed, singularly or in combination, in the valuation of closely held shares. Although the Internal Revenue Service warns against using a weighted average of different valuation procedures,[145] the weighted average method, as the culmination of the goal to consider all the relevant factors in the ultimate valuation, merits separate discussion.

Earnings value per share and net asset value per share are the primary values which should be averaged. These two values provide, by logical analysis, a completely adequate representation of the corporation's value. The properly adjusted net asset value reveals with mathematical precision the value of reproducing the assets that are necessary to the business operation. The other important variable to be included in the valuation formula, earnings value, shows the earning potential of these assets once they are used in the business operations. The earnings value, when calculated through capitalization of earnings, includes consideration of these factors which may have an effect on future earnings. Through the use of these two values, therefore, a wide range of factors is considered and then fused into two workable valuations which may be weighted and averaged into a final valuation.

The weight accorded each value is dependent upon the type of business in which the close corporation is involved. Ordinarily, the earnings value per share of corporations that produce goods and services should be given the heaviest weight. If the close corporation is an asset holding company, however, such as a real estate investment firm, net asset value may be assigned the heaviest weight. Other than these general guidelines, there is no well-defined test for determining what weight is to be assigned to the respective values. This is largely a matter of discretion to be exercised by those who have the burden of calculating a final valuation.

Dividend payments or payment capacity should be disregarded as irrelevant since the earnings value calculation would include the earnings represented by dividend paying capacity.[146] A hypothetically constructed market value should also not be a weighted factor included within the average since inaccuracies are involved in the construction.[147] However, a hypothetical market value constructed through the use of the comparable company approach may be useful as a guide to determine whether the earnings value figure is realistic.

Finally, the weighted average of the per share earnings value and the per share net asset value should be discounted by an adequate percentage to reflect the reduction in value resulting from the transfer

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[145] Rev. Rul. 59-60, 1959-1 CUM. BULL. 237-38.

[146] See notes 87 through 91 and accompanying text *supra*.

[147] See notes 92 through 105 and accompanying text *supra*.

of a minority interest, lack of stock marketability, and binding stock transfer restrictions.[148]

Admittedly, this method excludes the use of some valuation factors, including dividend paying capacity and market value, which the Internal Revenue Service and courts have considered important. It does seem, however, to take all factors into account which accurately reflect the small closely held corporation's value while excluding less relevant factors: those which do not consistently affect close corporate stock value. Moreover, its application is not overly complicated and the results are convincing. Therefore, parties and courts, if they desire a fair, accurate, and feasible approach to valuation, should carefully consider the weighted average method.

Conclusion

The valuation of shares in a closely held corporation is an essential but difficult and inexact process. Whether valuation is necessitated by a stock purchase agreement, a dissenting shareholder's assertion of the appraisal remedy, or the settlement of an estate, attempts must be made to fairly and accurately ascertain the value of the closely held shares.

In reaching a final determination various factors must be examined. Since most valuations are required after some type of taxable transfer, Internal Revenue Service guidelines are important. Characteristics common to closely held corporations, such as a clear majority interest, stock transfer restrictions, the lack of a ready market for the shares, and a noticeable shortage of dividends, must be carefully studied. Furthermore, the basic corporate attributes of net asset value and earnings value are significant determinants.

As a basic proposition, the judiciary, including the Mississippi Supreme Court, has failed to resolve the existing uncertainties in the process of valuing closely held shares. Courts have reached final valuations on the basis of a consideration of many interrelated factors, or one prevailing element, or without reliance on any definite circumstance. Due to this inconsistency in judicial interpretations and the confusing nature of the valuation procedure, the general adoption of a weighted average method could clarify this equivocal practice.

Although judicial application of the weighted average method may solve the problem of less than thorough or inaccurate court-determined valuations of closely held stock, the best way to avoid the problem is

[148] See notes 106 through 121 and accompanying text *supra*. Courts often overlook these factors resulting in a substantial overvaluation of the shares. *See* Moroney, *Most Courts Overvalue Closely Held Stocks*, 51 Taxes 144 (1973).

simply to deny the courts any opportunity to value the stock. A properly drafted stock purchase agreement can accomplish this objective by establishing the value of shares for any situation in which valuation may be necessary. The agreement obviously should determine the price for the purchase of shares from a withdrawing shareholder. If the proper provisions are included, the value set forth in the agreement will bind the Internal Revenue Service for estate tax purposes.[149] If the agreement specifies that the shareholder will accept the value if he dissents from a proposed corporate change, the agreement may also prevent court intervention under the appraisal statute.

The value to be included in the stock purchase agreement should be determined by the weighted average method in a meeting of all the shareholders who are to be parties to the agreement. The agreement should specify a dollar amount as the per share value since the use of a formula, book value, or other methods of valuation which invite different interpretations may allow a dispute to arise, and, as a result, judicial valuation. If the parties cannot agree on a per share value, the evaluation can be accomplished by independent appraisers. The parties involved should appoint two appraisers, expert in valuing closely held shares, to calculate a per share value. If the two appraisers are unable to agree, they should have the power to appoint a third appraiser to decide the question.

The agreement should further require that the corporation and all shareholders meet once a year to review the value included in the agreement and to make any necessary revisions. The process suggested for determining the value of the shares should be followed every year in which revision is necessary.

The major disadvantage of using appraisers to value shares in a closely held corporation is the expense involved in employing them. Litigation, however, is rarely less expensive than appraiser valuation due to attorneys' fees, expert witness fees, court costs, and the possibility of a valuation which is neither accurate nor agreeable to any of the parties involved.

In conclusion, the confusing and uncertain process of valuing closely held shares can be largely circumvented through the execution of a binding contractual agreement between the interested parties. If such an agreement was not, or could not, be consummated, the weighted average method provides the best method for the valuation of the closely held shares when the dispute reaches the courts.

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[149] See note 6 *supra*.

PUNITIVE DAMAGES AND THE FEDERAL SECURITIES ACT: RECOVERY VIA PENDENT JURISDICTION

Since the enactment of the Securities Act of 1933[1] and the Securities Exchange Act of 1934,[2] plaintiffs have sought compensation for injuries suffered due to another's violation of these acts. In these civil actions plaintiffs have characteristically sued to recover only compensatory damages; aggrieved parties in recent years, however, have embarked on a new course, seeking additional compensation in the form of punitive awards. Requests for punitive damages, when grounded solely upon alleged violations of the federal securities acts, have not been hospitably received by the federal courts. The relatively few punitive awards granted have generally been based on a common law fraud claim, cognizable under the federal doctrine of pendent jurisdiction,[3] joined with the alleged violation of the federal acts.

In 1975, this newly developed area of securities law was placed squarely in issue before the United States District Court for the Northern District of Mississippi in *Smith v. Milam*.[4] In that case, the plaintiff[5] purchased municipal bonds from the defendants[6] and participated in other transactions which led to substantial investment losses. Seeking to recover his losses, plaintiff filed suit charging the defendants with violations of the federal securities acts,[7] the Mississippi Blue Sky Laws,[8] and the Texas Securities Act;[9] additionally, plaintiff contended that the defendants were guilty of common law fraud.

In *Smith*, the plaintiff first purchased bridge and speedway bonds, which were payable from their respective operations.[10] Defendants were

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[1] 15 U.S.C. §§ 77a *et seq.* (1970) [hereinafter referred to as 1933 Act].

[2] *Id.* §§ 78a *et seq.* (1970) [hereinafter referred to as 1934 Act].

[3] See notes 111 through 135 and accompanying text *infra*.

[4] Civil No. DC 73-21-K (N.D. Miss., Aug. 12, 1975) (unreported).

[5] Charles L. Smith, a Texas citizen engaged in the oil field supply business, was found by the court to have had some experience in common stock transactions but none in municipal bonds. *Id.* at 2.

[6] The four defendants were: (1) Milam Investments, Incorporated, a Southaven, Mississippi municipal bond dealer which conducted operations from February 1, 1972, until April 20, 1973, when its dealer permit was revoked; (2) Wallace P. Milam, president of Milam Investments, Incorporated; (3) Dave Wilson, agent; and (4) Sam Lewis, agent.

[7] Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1970); Securities Exchange Act of 1934 § 10b, 15 U.S.C. § 78j(b) (1970); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1973).

[8] Miss. Code Ann. § 75-71-31 (1972). *See generally* Hodge, *Civil Liability under the Mississippi Securities Act*, 43 Miss. L.J. 597 (1972).

[9] Tex. Rev. Civ. Stat. Ann. art. 581-33 (1964).

[10] The East St. Louis, Illinois, Bridge bonds were to be repaid only from toll bridge receipts. Subsequent to their issuance, but prior to the sale by Milam to Smith, a toll-free bridge (adjacent to the toll bridge and part of the interstate highway system), was constructed and opened to the public. This occurrence, in effect, eliminated all profits from toll bridge operations.

aware of the highly speculative nature of the bonds but did not so inform the plaintiff, who did not realize the true nature of this investment. They subsequently persuaded the plaintiff to exchange his investments and to make additional investments.[11] The defendants not only misrepresented and omitted material facts but also charged the plaintiff excessive prices for the bonds.

In finding for the plaintiff, the court had little difficulty in holding that the defendants' actions constituted a violation of section 10(b) of the 1934 Act and Rule 10b-5.[12] Stating clearly that recovery under the federal securities laws was limited to actual damages,[13] the court held that punitive damages may be awarded where justified under a pendent state cause of action. Since the instant case presented such a claim, the court granted the plaintiff punitive damages, including attorneys' fees, of $100,000.[14]

Smith v. Milam is representative of current damages actions brought for securities law violations. The purpose of this comment is to explore the issues presented in *Smith* with particular emphasis on the origin, development, and current status of punitive damages under federal secutities laws.

I. Punitive Damages and Fraud: General Principles and the Mississippi View

Punitive damages[15] are awardable without regard to the plaintiff's actual losses. They are assessed in order to punish the defendant for his

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The Ontario, California, Speedway had consistently lost money since its inception, and the coupon payments were derived from reserves or accumulated capital.

[11] Initially, Smith was persuaded to purchase additional bridge bonds. The speedway bonds were later traded for more bridge bonds. Milam Investments, without Smith's knowledge or approval, exchanged the bridge bonds for Missouri Bi-State Development bonds. These Bi-State bonds were traded for speedway bonds which were, in turn, exchanged for State of Texas bonds without Smith's authorization. For a detailed listing of the transactions involved, see Smith v. Milam, Civil No. DC 73-21-K, at 6 n.2 (N.D. Miss., Aug. 12, 1975) (unreported).

[12] The SEC adopted Rule 10b-5 pursuant to the statutory authority expressly granted by Congress through section 10(b). See notes 62 and 63 *infra* for the literal language of section 10(b) and Rule 10b-5.

[13] Smith's loss on the investments was determined to be $73,947.61. This amount, plus legal interest thereon, constituted the "actual damages" awarded. Smith v. Milam, Civil No. DC 73-21-K, at 14 (N.D. Miss., Aug. 12, 1975) (unreported).

[14] Defendant Wilson was not held liable for punitive damages since he had not participated in, and was not aware of, the "rank deceptions" practiced by Lewis and for which Milam and Milam Investments were responsible. *Id.*

[15] Punitive damages are also referred to as "exemplary damages" and "smart money." C. McCormick, The Law of Damages § 77, at 275 (1935) [hereinafter cited as McCormick]; W. Prosser, The Law of Torts § 2, at 9 (4th ed. 1971) [hereinafter cited as Prosser].

misconduct and to deter others from similar activities.[16] While there has been controversy over the policies supporting the award of punitive damages,[17] one authority has noted: "[T]hey are an established part of our legal system, and there is no indication of any present desire or tendency to abandon them."[18]

An award of punitive damages requires more than the commission of a wrongful act.

> It must be shown either that the defendant was actuated by ill will, malice, or evil motive (which may appear by direct evidence of such motive, or from the inherent character of the tort itself, or from the oppressive character of his conduct, sometimes called "circumstances of aggravation"), or by fraudulent purposes, or that he was so wanton and reckless as to evince a conscious disregard of the rights of others.[19]

Such damages are, by their nature, a windfall to the plaintiff, and their award is entirely discretionary with the jury.[20]

Mississippi law is apparently in accord with the generally accepted principles in this area.[21] The conduct of the wrongdoer in a given situation is deemed to be determinative in assessing the propriety of punitive damages. Consequently, punitive awards have been made in a variety of tort actions.[22] The common thread throughout the Mississippi decisions is the finding that "the alleged wrong done the plaintiff is such as to import insult, fraud, oppression, or a reckless disregard for the rights of the plaintiff."[23] It should be noted, however, that a chancery court may not award punitive damages unless authority therefor is expressly given or necessarily implied by statute.[24]

Since a finding of fraud is dependent on the circumstances in each

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[16] McCormick § 77, at 275; Prosser § 2, at 9.

[17] *See* McCormick § 77, at 275-76; Prosser § 2, at 11.

[18] Prosser § 2, at 11. Four states—Louisiana, Massachusetts, Nebraska, and Washington—have totally rejected punitive damages, and England retains the award only where it can serve a "useful purpose." *Id.* at 9 n.61.

[19] McCormick § 79, at 280 (footnotes omitted).

[20] Prosser § 2, at 13.

[21] *See generally* Comment, *Punitive Damages in Mississippi—A Brief Survey*, 37 Miss. L.J. 131 (1965).

[22] *Id.* at 132-33.

[23] T.G. Blackwell Chevrolet Co. v. Eshee, 261 So. 2d 481, 485 (Miss. 1972); *see, e.g.*, Friendly Fin. Co. v. Mallett, 243 So. 2d 403, 407 (Miss. 1971); Kinnard v. Martin, 223 So. 2d 300, 302 (Miss. 1969); Richardson v. Byrd, 215 So. 2d 424, 425 (Miss. 1968); Fowler Butane Gas Co. v. Varner, 244 Miss. 130, 150-51, 141 So. 2d 226, 233 (1962).

[24] Comment, *supra* note 21, at 132; *see, e.g.*, Carl v. Craft, 258 So. 2d 237, 241 (Miss. 1972); Equity Serv. Co. v. Hamilton, 257 So. 2d 201, 207 (Miss. 1972); Kemp v. Lake Serene Property Owners Ass'n, Inc., 256 So. 2d 924, 926 (Miss. 1971). This attitude presents an interesting question: Whether a federal court, sitting in equity and applying Mississippi law in deciding a state law claim, can properly award punitive damages.

case, the common law concept of fraud almost defies definition. Generally, fraud includes

> all acts, omissions, and concealments involving a breach of legal or equitable duty and resulting in damage to another, or the taking of undue or unconscientious advantage of another; and, conversely, fraud cannot exist without a breach of legal or equitable duty . . . .[25]

Numerous lists of the requisite elements of fraud have been compiled, but all incorporate the same basic concepts. In order to find fraud in a given situation, it must be determined that there has been a false representation of a material fact, that the defendant knew of its falsity and acted affirmatively to persuade the plaintiff to rely on it, and that the plaintiff justifiably relied on it and thereby suffered damage.[26] The decisions of the Mississippi Supreme Court are in accord with these principles.[27] The facts and circumstances which constitute fraud must be clearly alleged and proved by clear and convincing evidence.[28]

Notably, the federal courts have liberalized the proof requirements for showing fraud in suits brought under the federal securities acts. This liberalization is evidenced by the recognition of an action against any person causing injury to another through omission or misstatement of material facts.[29]

II. Punitive Damages Under the Federal Securities Acts

A. Express Liability Provisions

Sections 11 and 12 of the 1933 Act expressly create private causes of action for the recovery of damages. Section 11[30] provides for civil liability where material facts are improperly stated in, or omitted from, the registration statement.[31] Since this section furnishes a formula for damage recovery[32] and specifically states that "[i]n no case shall the

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[25] 37 C.J.S. *Fraud* § 1, at 204 (1943) (footnotes omitted).

[26] Burkhart v. Allson Realty Trust, 363 F. Supp. 1286, 1291 (N.D. Ill. 1973); *see* 37 Am. Jur. 2d *Fraud and Deceit* § 12, at 34 (1968); 37 C.J.S. *Fraud* § 3, 215-18 (1943).

[27] *See* McMahon v. McMahon, 247 Miss. 822, 836, 157 So. 2d 494, 501 (1963); Anderson Dunham, Inc. v. Aiken, 241 Miss. 756, 761, 133 So. 2d 527, 529 (1961); Gardner v. State, 235 Miss. 119, 130, 108 So. 2d 592, 594 (1959).

[28] McMahon v. McMahon, 247 Miss. 822, 836, 157 So. 2d 494, 501 (1963).

[29] Comment, *Punitive Damages Under Section 17(a) of the 1933 Securities Act*, 1970 U. Ill. L.F. 296, 300-01.

[30] Securities Act of 1933, 15 U.S.C. § 77k (1970).

[31] *Id.* § 11(a), 15 U.S.C. § 77k(a)(1970) provides in part:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may . . . sue . . . .

[32] *Id.* § 11(c), 15 U.S.C. § 77k(c) (1970).

amount recoverable under this section exceed the price at which the security was offered to the public,"[33] punitive damages are not available.[34]

Section 12(1)[35] imposes civil liability upon one who offers or sells a security in violation of section 5.[36] Section 12(2)[37] provides a civil remedy against one who offers or sells a security by a prospectus or oral communication containing a material misstatement or omission of material facts. Damages under both of these subsections are controlled by the section's specific language providing that the purchaser

> may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.[38]

This restrictive language would appear to preclude the award of punitive damages under section 12, especially since the statute expressly provides for rescission.[39] Though it could be argued that the stipulation allowing damages does not operate to deny an exemplary award,[40] punitive damages are basically foreign to section 12 actions.[41] Proof of fraudulent intent is not a prerequisite to recovery under section 12.[42] Since

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[33] *Id.* § 11(g), 15 U.S.C. § 77k(g)(1970).

[34] "It is evident that the Congress intended to make the action, notwithstanding its origin in fraud, *purely compensatory*." Shonts v. Hirliman, 28 F. Supp. 478, 482 (S.D. Cal. 1939)(emphasis in original).

[35] 15 U.S.C. § 77*l*(1) (1970).

[36] *Id.* § 77e (1970). This section provides that it is unlawful for any person to use any means of transportation or communication in interstate commerce or the mails to sell an unregistered security.

[37] *Id.* § 77*l*(2) (1970).

[38] *Id.* § 77*l* (1970).

[39] *See* Avern Trust v. Clarke, 415 F.2d 1238, 1242 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1971); Burkhart v. Allson Realty Trust, 363 F. Supp. 1286, 1290 (N.D. Ill. 1973).

[40] It could just as easily be argued that this rationale results in inconsistent application of the section; if a person still has possession of the security he is only entitled to rescission, but if he has sold the security he may be entitled to a punitive award.

[41] *See* Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 697 (5th Cir. 1971) (punitive damages not available under § 12); Burkhart v. Allson Realty Trust, 363 F. Supp. 1286, 1290 (N.D. Ill. 1973) (only actual damages recoverable under § 12). *But see* Nagel v. Prescott & Co., 36 F.R.D. 445 (N.D. Ohio 1964). The action in *Nagel* was based on defendants' objections to interrogatories. In treating a portion of plaintiff's complaint based on § 12(2), the court, in dictum, stated: "Although there is no provision in the Securities Act authorizing recovery of punitive damages, it is clear that the plaintiffs may recover upon a proper showing of maliciously improper conduct." *Id.* at 449.

[42] Lewis v. Walston & Co., 487 F.2d 617, 621 (5th Cir. 1973) (absolute liability under § 12(1); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 695 (5th Cir. 1971) (proof of scienter not necessary under § 12(2)); Phillips v. Alabama Credit Corp., 403 F.2d 693 (5th Cir.1968)(proof of fraudulent intent not required under § 12(2)); Johns

there is no need to show ill will or malice, actions under this section are easily distinguishable from those based on tort and common law theories which may justify punitive damages.[43]

Sections 9(e), 16(b), and 18(a) of the 1934 Act expressly authorize suits for damages. Section 9(e)[44] provides that any person "who wilfully participates in any act or transaction in violation of" the other provisions of that section[45] "shall be liable to any person" whose purchase or sale of a security was affected by the transaction. The injured parties may sue under section 9(e) "to recover the damages sustained as a result of any such act or transaction." The specific language of section 9(e), therefore, seemingly closes the door on punitive damages.[46]

Sections 16(b) and 18(a) also supply mechanisms for the measurement of damages, thereby effectively precluding exemplary awards. Section 16(b),[47] which regulates profits on short-swing trading by named insiders, sanctions only a "suit to recover such profit." Imposing liability on anyone who makes material false or misleading statements in any document filed with a national securities exchange, section 18(a)[48] stipulates that such persons may be held accountable "for damages caused by such reliance."

Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1219 (D. Md. 1968)(evil motive not required for § 12(2) violation), *aff'd in part, rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1971).

[43] *See* notes 19 through 23 and accompanying text *supra*.

[44] 15 U.S.C. § 78i(e)(1970).

[45] *Id.* §§ 78i(a), (b), (c) (1970). These provisions basically attempt to prohibit manipulation of securities registered on exchanges.

[46] Section 9(e) also provides that "the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including attorney's fees, against either party litigant." This language trivializes the contention that punitive awards of a compensatory nature should be recognized. Section 11(e) of the 1933 Act, 15 U.S.C. § 77k(e)(1970), and section 18(a) of the 1934 Act, 15 U.S.C. § 78r(a)(1970), both contain virtually the same provisions. Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b)(1970), does not so provide. However, a shareholder bringing a derivative suit under section 16(b) may demand reimbursement of his expenses from the corporation. Magida v. Continental Can Co., 176 F. Supp. 781, 782 (S.D.N.Y. 1956). *See* Comment, *The Availability of Punitive Damages for Express and Implied Causes of Action Under the Securities Act of 1933 and the Securities Exchanges Act of 1934*, 43 TEMP. L.Q. 140, 141-43 (1970).

The issue of punitive damages under section 9(e) is relatively insignificant as very few actions are brought under this section, primarily because of the stringent proof of causation requirement. The plaintiff must not only prove that the damages were "sustained as a result" of manipulation, but also that the price at which he purchased or sold "was affected by such act or transaction." *See* 3 L. LOSS, SECURITIES REGULATION 1748 (2d ed. 1961). Section 18(a) contains similar provisions as well as providing an escape valve for the defendant if he acted in good faith. *Id.* at 1752.

[47] 15 U.S.C. § 78p(b)(1970).

[48] *Id.* § 78r(a)(1970).

The apparent rejection of punitive damages in sections 9(e), 16(b), and 18(a) of the 1934 Act is reinforced by section 28(a)[49] of that Act. Section 28(a) provides:

> [N]o person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions· a total amount in excess of his actual damages on account of the act complained of.

Section 28(a) has not only been construed to prohibit punitive damages under these express liability provisions,[50] but it also has been extensively cited as the basis for the disallowance of exemplary awards in implied actions under the 1934 Act.[51]

B. Implied Civil Actions

"Implied" actions under the federal securities acts are those derived from sections which fail to provide express remedies for specified statutory violations. It is apparent that if such sections are to be effectively implemented, appropriate civil remedies must be devised by the courts. The existence of an implied cause of action for violation of the antifraud provisions was first noted in *Kardon v. National Gypsum Co.*[52] The plaintiffs alleged that defendants violated section 10(b) of the 1934 Act and Rule 10b-5 by inducing them to sell their stock at a price well below its true value. The defendants argued that legislative intent to deny the right to recover damages could be deduced from the fact that sections 9, 16 and 18 of the 1934 Act expressly provide for civil actions by injured parties, but section 10 does not. The court rejected this contention, however, noting that "in view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies."[53] The existence of a private cause of action under Rule 10b-5 is now well accepted.[54]

An implied right of action was also held to exist for violations of section 17(a) of the 1933 Act in *Osborne v. Mallory*.[55] The court there stated:

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[49] *Id.* § 78bb(a)(1970).

[50] *See* Hirsch & Lewis, *Punitive Damage Awards Under the Federal Securities Acts*, 47 NOTRE DAME LAW. 72, 80 (1972); Comment, *supra* note 46, at 142.

[51] *See* notes 64 through 67 and accompanying text *infra*.

[52] 69 F. Supp. 512 (E.D. Pa. 1946).

[53] *Id.* at 514. The private right of action recognized by the court could be based upon one of two theories: (1) common law tort principles; or (2) section 29(b) of the 1934 Act, which voids all contracts in violation of any provision of the Act. *Id.* at 513-14; Comment, *supra* note 46, at 143.

[54] Comment, *supra* note 46, at 140; *see* Comment, *Measurement of Damages in Private Actions Under Rule 10b-5*, 1968 WASH. U.L.Q. 165, 165 n.2.

[55] 86 F. Supp. 869 (S.D.N.Y. 1949).

> Even though there is no specific section of the 1933 Act creating liability under § 17 other than the language of § 17 itself . . . it has been held that a civil liability is implied and a remedy is available . . . for violations . . . .[56]

In order to give proper effect to implied causes of action, courts must have the power to devise appropriate remedies. Federal courts possess substantial powers to accomplish this objective.[57] *J.I. Case Co. v. Borak*[58] applied this concept to the federal securities laws. A stockholder of J.I. Case Company alleged that a merger was accomplished by the distribution of a false and misleading proxy statement.[59] Mr. Justice Clark, speaking for the United States Supreme Court, noted that one of the primary purposes of the 1934 Act is investor protection[60] and called on the courts to remain alert to provide remedies necessary to effectuate congressional intent.[61]

1. The 1934 Act: Section 10(b) and Rule 10b-5

The availability of punitive damages in implied actions under the 1934 Act centers around actions brought under section 10(b)[62] and Rule

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[56] *Id.* at 879.

[57] Comment, *Punitive Damages in Implied Civil Actions Under the Federal Securities Laws: The Need for Flexibility*, 17 U.C.L.A.L. REV. 1280, 1292-93 (1970).

[58] 377 U.S. 426 (1964).

[59] The complaint contained two counts: (1) breach of the directors' fiduciary duties (jurisdiction based on diversity); and (2) violation of section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1970), which deals with proxy solicitation. 377 U.S. at 427.

[60] 377 U.S. at 432.

[61] *Id.* at 433. The Supreme Court, in the recent decision of Cort v. Ash, 422 U.S. 66, 78 (1975), set forth the circumstances relevant to the decision whether a private cause of action may be implied: (1) The plaintiff must be a member of the class for whose especial benefit the statute was enacted; (2) there must have been legislative intent to create a private remedy; (3) an implied private remedy should effectuate the underlying legislative purpose; and (4) the cause of action must not be one traditionally relegated to state law. The *Cort* opinion, however, carefully distinguished the situation in which there is "a pervasive legislative scheme governing the relationship between the plaintiff class and the defendant class in a particular regard . . . ." *Id.* at 82, *citing* J.I. Case Co. v. Borak, 377 U.S. 426 (1964). *See generally* 46 MISS. L.J. 156 (1976).

[62] Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchanges—
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> To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b)(1970).

10b-5.[63] Although courts have differed in their treatment of punitive damage claims, the prevailing view disallows exemplary awards in actions under the 1934 Act.

The starting point in determining whether punitive damages may be awarded under the 1934 Act is section 28(a).[64] Read literally, this section limits recoveries for violations of the 1934 Act to "actual damages."[65] The argument has been made, however, that the section was not intended as an absolute bar to recovery of punitive damages, but rather was intended merely to preclude double recovery of compensatory damages on federal and state claims arising out of the same transaction.[66] The scope of section 28(a) has also given rise to a divergence of opinion. It has been contended that this section should apply only to those suits expressly authorized by the 1934 Act. Others read the statute more broadly, reasoning that since all sections of the Act are subject to section 28(a), implied civil actions should be subject to the same limitations as those suits expressly authorized.[67]

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[63] Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of a national securities exchange, (1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1973).

[64] 15 U.S.C. § 78bb(a)(1970).

[65] Section 28(a) provides in part:

> The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

Id.

The term "actual damages" has been subject to differing interpretations. The court in Estate Counseling Serv., Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962), stated that actual damages are controlled by the "out of pocket rule" — the difference between the amount parted with and the value of the thing received.

Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 939 (1965), however, did not adopt such a limitation. The court, finding a defrauded party more entitled to windfalls than the perpetrators of the fraud, sanctioned the award of an amount in excess of out-of-pocket losses. 344 F.2d at 786.

Awards of lost profits (in excess of the plaintiff's out-of-pocket losses), are to be distinguished from punitive awards, which could result in the impairment of the fraudulent party's financial condition. Hirsch & Lewis, *supra* note 50, at 78-79.

[66] 3A H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 8.26[5], at 8-78 (1975).

[67] Hirsch & Lewis, *supra* note 50, at 77.

Although early attempts to obtain punitive damages generally failed,[68] it was not until 1968 that a court of appeals directly confronted this issue. *Green v. Wolf Corp.*[69] provided the factual setting for the initial extensive treatment of exemplary awards under the securities laws. The plaintiff charged that Wolf Corporation violated section 10(b) and Rule 10b-5 by including in a registration statement untrue and misleading statements.[70] Although Green's actual damages were less than $1,000, he asserted a claim for punitive damages. Green's primary argument was that the sole intent of section 28(a) was to preclude "double recovery."[71]

The Second Circuit held that section 28(a) operated to limit dam-

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[68] Mills v. Sarjem Corp., 133 F. Supp. 753 (D.N.J. 1955), involved an action by shareholders against several corporations, in which violations of, *inter alia*, section 10(b) and Rule 10b-5 were alleged. The plaintiffs' claim for punitive damages was summarily rejected. Citing only section 28(a), the court held that such plaintiffs "are not in any event entitled to more than *actual* damages." *Id.* at 770 (emphasis in original).

Meisel v. North Jersey Trust Co., 216 F. Supp. 469 (S.D.N.Y. 1963), presented a motion to strike a claim for punitive damages in an action based on violations of the 1934 Act. The court granted defendant's motion since it viewed section 28 as absolutely precluding recovery in excess of actual damages.

In Pappas v. Moss, 257 F. Supp. 345 (D.N.J. 1966), *rev'd on other grounds*, 393 F.2d 865 (3d Cir. 1968), minority shareholders instituted an action against a corporation and some of its officers and directors alleging violations of their common law obligations to the corporation and Rule 10b-5. After noting that actual damages are recoverable, the court rejected the claim for punitive damages.

Other cases, however, indicated that section 28(a) does not operate to deny exemplary damages. In Baumel v. Rosen, 283 F. Supp. 128 (D. Md. 1968), *aff'd in part, rev'd in part*, 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970), the court allowed an award in excess of actual out-of-pocket losses in a Rule 10b-5 action. The court held that 28(a) merely precluded double recovery, and that it was applicable only to suits specifically authorized by the 1934 Act. Though the issue of punitive damages was not directly confronted, it can be logically inferred that this court would not have refused to award punitive damages solely because of the limiting language of section 28(a). *See* 283 F. Supp. at 144-45.

Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified*, 430 F. 2d 1202 (9th Cir. 1970), involved allegations that the defendant brokers "churned" plaintiff's account to produce additional profits for the firm in violation of the federal securities laws. In dictum, the court stated that section 28(a) applied only to actions expressly authorized by the 1934 Act and that exemplary damages may be appropriate in federal securities actions under general tort principles. 283 F. Supp. at 444-45.

[69] 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

[70] Wolf Corporation planned to issue common stock and subordinated debentures which were to be exchanged for the interests of various limited partners in a real estate syndicate (whose general partners had formed Wolf Corporation). Green, one of the limited partners, also bought stock on the open market; this purchase was the basis of the class action suit. Green stated that he and the members of the class relied on the overstatement of "Cash Available for Distribution to Shareholders." 406 F.2d at 294-95.

[71] *Id.* at 302; see text accompanying note 66 *supra*.

ages in an action under the 1934 Act to "actual damages."[72] Noting that legislative history offered little guidance in resolving this question,[73] the court, nevertheless, justified its decision by stating that it did not believe that Congress intended the 1934 Act to be a device for the recovery of "grossly disproportionate" judgments.[74] Since the court felt that punitive damages were available under the 1933 Act, it distinguished the potential liabilities under the two Acts in further support of the denial of punitive damages under the 1934 Act.[75] Broadening the scope of its inquiry into the propriety of an exemplary award, the court stated that punitive damages should serve "only as retribution or as a deterrent measure." Consideration of the factors involved in *Green* led to the conclusion that neither policy would be furthered by the availability of punitive damages.[76]

The *Green* decision was apparently based on a strict interpretation of section 28(a) and a conservative analysis of the policies involved. The court's reading of 28(a) is a reasonable one since an award of punitive damages is, by its very nature, in excess of actual damages. Adequate grounds exist, however, for asserting that the court did not properly interpret section 28(a). Viewing the section as a savings clause designed to preserve existing remedies, it could be deemed inappropriate to interpret section 28(a) as prohibiting the traditional punitive damages remedy.[77] The significance of the court's treatment of the policies supporting exemplary awards is suspect in this respect: If section 28(a) clearly precludes exemplary awards, as the court maintains, no further justification would seem to be necessary.[78]

The position adopted by the *Green* court was strengthened by the

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[72] The court, recognizing that there was no definitive federal appellate explanation, adopted the views of lower courts which had given this construction to the statute. *Id.* at 302.

[73] *Id.*, *citing* H.R. REP. No. 1383, 73d Cong., 2d Sess. 28 (1934).

[74] The court was unable to "ignore" the propensity of some juries to award "capricious" punitive damages. *See* 406 F.2d at 303 n. 18.

[75] It was reasoned that since the 1933 Act contained no provision similar to section 28(a) of the 1934 Act, Congress could have intended to impose different liabilities under the two Acts. Further, lighter penalties under the 1934 Act could encourage corporations to register on the exchanges. 406 F.2d at 303 (adopting the rationale of the district court in Globus v. Law Research Serv., Inc., 287 F. Supp. 188 (S.D.N.Y. 1968)). Judge Kaufman subsequently indicated that "it is obvious to the careful reader that this [statement] was merely dicta." Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1286 n.12 (2d Cir. 1969).

[76] The burden, in the court's opinion, would ultimately fall on all the stockholders, including those free from guilt. Ample deterrent measures were found in the availability of class actions, derivative suits, and other such procedural devices, and the presence of criminal penalties in section 32 of the 1934 Act, 15 U.S.C. § 78ff (1970).

[77] *See* Comment, *supra* note 57, at 1286-87.

[78] On the other hand, it is improper to engage in statutory interpretation without some consideration of the policy which the statute in question was designed to further.

Tenth Circuit's decision in *deHaas v. Empire Petroleum Co.*[79] In that case the plaintiff brought a stockholder's derivative action against Empire seeking damages and equitable relief for alleged violations of Rule 10b-5. The district court, finding for the plaintiff, awarded punitive damages.[80] Reversing the exemplary award, the Tenth Circuit, unlike the Second Circuit, found that section 28(a) offered an insufficient basis for a definitive ruling on this point. Stating that the literal language of the 1934 Act and its legislative history provided minimal guidance for interpretation, the court found that conflicting interpretations of the meaning of section 28(a)[81] required that the punitive damages question be resolved on policy considerations.[82]

The court pointed out that punitive damages serve the purposes of deterrence and retribution against individual defendants and also provide an incentive for individuals to bring private actions when public officials cannot effectively police the field. In the court's opinion, however, these benefits were to be evaluated in light of the attendant problems.[83] The court's balancing process resulted in the determination that the dangers accompanying punitive awards were so great as to override possible benefits; thus, punitive damages were denied.[84]

2. The 1933 Act: Section 17(a)[85]

Upon enactment of the Securities Act in 1933, it was the general

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[79] 435 F.2d 1223 (10th Cir. 1970).

[80] Defendants Empire Petroleum Company and Stone (the holder of important ownership interests and management offices in all of the corporations involved), were adjudged liable for $60,000; an additional $5,000 was assessed against Stone as punitive damages.

[81] The court, recognizing the apparent conflict, cited *Green* for the proposition that some courts employ section 28(a) to limit recovery in Rule 10b-5 actions. Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), was cited as representative of the view that section 28(a) is applicable only to actions expressly created by the 1934 Act. The court also alluded to the theory that section 28(a) was intended solely to bar "double recovery." 435 F.2d at 1230.

[82] "Absent a clear answer from the Act itself, we must base our holding upon an analysis of the policies underlying the securities laws and the awarding of punitive damages." 435 F.2d at 1230.

[83] *Id.*

[84] The court perceived the primary attribute of exemplary awards to be their possible aid in security law enforcement. Noting the presence of criminal sanctions in the 1934 Act and the availability of class actions, the court felt that the presence of these "potent" remedies significantly reduced the importance of punitive damages.

Major problems recognized with regard to exemplary awards were excessive jury verdicts, placement of the ultimate burden on innocent shareholders, and the lack of an adequate means of controlling multiple jury verdicts against a single defendant. *Id.* at 1230-31.

[85] Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a)(1970) provides:

consensus that the only civil damage sections were those expressly provided in sections 11 and 12. Since section 17(a) failed to provide a civil remedy, violations of its provisions were redressable only by injunction or criminal sanctions.[86] After the establishment of the idea that an injured buyer had a private action under Rule 10b-5, however, little justification remained for denying the existence of such an action under section 17(a).[87] As a result of the courts' restrictive interpretation of remedies available under section 17(a) and their broad construction of section 10(b) and Rule 10b-5, there have been few decisions in this area based on the 1933 Act. Punitive damages have been sought for violations of section 17(a), but it now seems that such awards are, as under the 1934 Act, not allowable.[88]

The landmark decision on punitive damages under section 17(a) is *Globus v. Law Research Service, Inc.*[89] Law Research Service, Incorporated (LRS) was formed to utilize computer technology in legal research. Seeking greater expertise in computerization, LRS entered into a contract with the Univac divisions of Sperry Rand Corporation. Shortly after organization, LRS made a public offering of stock to enable it to pay certain debts owed Sperry Rand and expand its own operations. Plaintiffs claimed that material omissions from the offering circular[90] constituted violations of section 17(a) and section 10(b) and amounted to common law fraud. Determining that the defendants had violated

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It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[86] Comment, *supra* note 29, at 298.

[87] *Id.* at 300; *see* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968)(Friendly, J., concurring), *cert. denied sub nom.*, Coates v. SEC, 394 U.S. 976 (1969); Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1093-95 (E.D. Pa. 1972).

[88] The only authority generally cited for the propositon that punitive damages are recoverable under the 1933 Act is Nagel v. Prescott, 36 F.R.D. 445 (N.D. Ohio 1964). In the context of motions to strike interrogatories, the court, in dictum, stated that despite the absence of a provision in the 1933 Act providing for the recovery of exemplary damages, they could be recovered if maliciously improper conduct was proved. *Id.* at 449.

[89] 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

[90] LRS had become indebted to Sperry Rand for $82,000. On the basis of the debt, dissension between LRS and Sperry Rand grew with the disagreements resulting in (1) Sperry Rand's refusal to allow LRS to use its computers and (2) the initiation by LRS of a suit against Sperry Rand. These two events were the "material facts" which the plaintiffs (purchasers of the LRS stock) claimed were omitted from the offering circular.

both the 1933 and 1934 Acts,[91] the jury awarded compensatory damages to all plaintiffs. In addition, punitive damages, based on violations of section 17(a) of the 1933 Act, were assessed against the president of LRS and the underwriter in charge of the public offering.

The Second Circuit, reversing the exemplary award,[92] scrutinized the contribution punitive damages would make toward effective enforcement of the 1933 Act.[93] Though conceding that punitive damages could act as a deterrent, the court found that such damages would make only a minimal addition to the currently existing "arsenal of weapons."[94] The force of the deterrence argument was further reduced by the court's recognition of the proposition that an award of punitive damages could potentially impose brutal injuries since a 17(a) violation seldom affects only a single purchaser.[95] Additionally, the court stated that it knew of no effective way to fairly restrict a punitive award.[96]

In concluding that punitive damages must be denied, the court pointed to the creation of an "unfortunate dichotomy between the 1933 and 1934 Acts" if an exemplary award were available under section 17(a). The preclusion of punitive damages by section 28(a) for actions

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[91] The defendants were found not guilty of common law fraud. For a discussion of the significance of the common law fraud claim, *see* notes 111 through 135 and accompanying text *infra*.

[92] The trial court had denied plaintiffs punitive damages under the 1934 Act on the basis of *Green*. The Second Circuit summarily affirmed this denial and addressed itself to the issue of punitive damages under the 1933 Act. The court also noted that some disagreement existed as to the availability of a private action under section 17(a); however, since it was affirming only an award of compensatory damages which could be based on either section 17(a) or section 10(b) of the 1934 Act, the court saw no need to extensively treat this issue. 418 F.2d at 1283.

Globus also involved a claim for indemnification which will not be considered in this comment.

[93] The court first recognized the contrary positions assumed by courts as to exemplary awards in implied actions under specific statutes. Rather than choose one of these positions, the court examined the congressional history of section 17(a) and the possibility that it should be treated solely as an express liability provision. Feeling that this also was not solid ground for its decision, the court stated: "The seminal question is whether punitive damage recovery is necessary for the effective enforcement of the Act." *Id.* at 1284.

[94] 15 U.S.C. § 77x (1970) provides for a fine and 5 years imprisonment for violations of section 17(a). The court also emphasized that: (1) the SEC can suspend or expel violators of the securities acts as well as suspend trading in a particular stock; (2) private actions, through large recoveries, can be an effective deterrent; and (3) class actions can themselves provide a windfall similar to that of punitive damages. 418 F.2d at 1285.

[95] The court was admittedly bothered by the possibility that a basically honest underwriter or issuer could be financially ruined if he "egregiously erred in one instance which affected many." 418 F.2d at 1285.

[96] The court felt that there was no way to be certain that all possible plaintiffs would be joined in one suit, nor was there any way of knowing how many suits would result from the single fraudulent act. *Id.*

under the 1934 Act was said to deprive defrauded sellers of their only basis for such relief. Thus, since the 1933 Act only protects purchasers, a punitive award under the 1933 Act "would create an unreasoned split between buyers and sellers of securities subjected to fraud of an equally heinous nature."[97] The Second Circuit also emphasized that courts have sought to treat the two Acts in pari materia—as an all-encompassing scheme of regulation—to obviate such incongruities.[98]

3. *Green, deHaas*, and *Globus*: An Overview of Policy

Analysis of the major decisions reveals that policy considerations have occupied a crucial role in the denial of punitive damages under the federal securities laws.[99] Several themes—criminal penalties, class actions, jury abuse, and successive punitive damage awards—were present in *Green, deHaas*, and *Globus*. These considerations merit further discussion.

Finding criminal penalties an adequate means of enforcement, the courts have concluded that there is no need for punitive damages. Though stringent enforcement of the criminal sanctions provided by the 1933 and 1934 acts—potentially a $5,000 fine and/or a 5-year prison sentence under the 1933 Act[100] or a $10,000 fine and/or a 2-year prison sentence under the 1934 Act[101]—might have some deterrent effect, fines of the specified magnitude would seem insignificant in large-scale securities transactions.[102] Moreover, actual enforcement of these penalties seems to have been somewhat lax, the result being a dilution of the theoretical deterrent provided by the sanctions. The availability of punitive damages to a private plaintiff would, therefore, certainly aid enforcement of the federal securities laws.[103] In arguing that punitive dam-

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[97] *Id.* at 1286.

[98] *Id.* An extension of this rationale effectively results in the application of section 28(a) of the 1934 Act to the 1933 Act. Thus, the fact that the 1933 Act does not have a section containing a general damages limitation, as section 28(a) is often construed, is of little consequence. *See* Green v. Wolf Corp., 406 F.2d 291, 303 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969) (no general damages limitation in 1933 Act).

[99] Only in *Green* did a court even attempt to premise its decision on another ground (section 28(a)). The courts in *deHass* and *Globus* recognized these other possibilities but expressly refused to rely on them. deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1230 (10th Cir. 1970); Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1286 n.11(2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

[100] 15 U.S.C. § 77x (1970).

[101] *Id.* § 78ff (1970).

[102] Regardless of the size of the transaction and the possible imposition of a monetary penalty, it is difficult to contend that the threat of imprisonment has an insignificant deterrent effect.

[103] *See* Comment, *Punitive Damages for Securities Regulation*, 8 HOUSTON L. REV. 137, 150 (1970).

ages will not significantly deter violations because of the presence of criminal penalties, the Second and Tenth Circuits seem to be concerned with duplication of penal effect. This should not be deemed crucial, since exemplary awards, by their nature, are supplemental to some other remedy.[104]

The availability of class actions has been set forth as a means of ensuring compliance with the securities laws. This assumption, however, overlooks the likelihood that the incentive for maintaining such an action may not be present when the class is comparatively small. Furthermore, the federal courts have recently exhibited a restrictive attitude towards the availability of the class action device.[105] In this regard, the United States Supreme Court's position in *Eisen v. Carlisle & Jacquelin*[106] is instructive. There, the Court ruled that the plaintiff, an odd-lot dealer on the New York Stock Exchange, in order to maintain a class action, was required to strictly comply with Federal Rule of Civil Procedure 23(c)(2) and give individual notice to each member of the class identifiable "through reasonable effort"—some 2,250,000 persons.[107] Such a burden, placed on a class action plaintiff, effectively eliminates the class action and its concomitant deterrent effect.[108]

The denial of punitive damages because of potential jury abuse presupposes that such abuse would be prevalent. In the absence of such a showing, and since the court has the power to order remittitur when the jury's award is deemed excessive, the rationale of feared jury abuse seems weak, and punitive damages should be available where warranted by the attendant facts and circumstances.[109]

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[104] *See* Hirsch & Lewis, *supra* note 50, at 83.

[105] *See* Zahn v. International Paper Co., 414 U.S. 291 (1973); Snyder v. Harris, 394 U.S. 332 (1969); Katz v. Carte Blanche Corp., 496 F.2d 747 (3d Cir.), *cert. denied*, 419 U.S. 885 (1974). *See generally* Comment, *Federal and State Class Actions: Developments and Opportunities*, 46 MISS. L.J. 39 (1975).

[106] 417 U.S. 156 (1974).

[107] *Id.* at 178-79.

[108] Both the onus of notification and the deterrent effect of sizable compensatory damage awards depend on the existence of a large class. The deterrence allegedly present in the threat of a class action is thus largely stilled by its own procedural prerequisites.

[109] The courts seem to be concerned with the possible recurrence of instances similar to the somewhat unique decision in Butts v. Curtis Publishing Co., 225 F. Supp. 916 (N.D. Ga. 1964), *aff'd*, 351 F.2d 702 (1965), *aff'd*, 388 U.S. 130 (1966). In *Butts*, the court reduced a $3,000,000 jury verdict for punitive damages to $400,000, recognizing its duty to keep the exemplary award "within reasonable bounds." *Id.* at 920.

Jury awards have hardly fulfilled the courts' fearful expectations. *See* deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1224 (10th Cir. 1970) (actual damages of $60,000; punitive damages of $5,000); Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1279 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970)(actual damages of $32,591.14; punitive damages of $39,812.06).

In response to the possibility of remittitur, *deHass* asserts that such "post-verdict

Perhaps the most valid fear of the courts is that of successive exemplary awards. Admittedly, it is difficult to guarantee that all plaintiffs are joined in a single action for the same wrong. Furthermore, a limitation of punitive damages to the first plaintiff would be unjust. On the other hand, fear of successive punitive awards may be unwarranted since effective solutions may exist in the establishment of "funds" or the consolidation of all exemplary awards in the litigation of a given class.[110]

III. Pendent Jurisdiction

Although punitive damages now seem to be unavailable under federal securities laws, this remedy is apparently still available to a defrauded party if he follows the proper procedure. Victims of state securities law violations and common law fraud have received punitive damages in recent decisions by invoking the doctrine of pendent jursidction. The state claims, heard in conjunction with the federal claims, have served as the basis for the exemplary awards.

A. Basic Principles

The United States Supreme Court extensively discussed the conditions under which a federal court could properly hear pendent state claims in *United Mine Workers v. Gibbs*.[111] Mr. Justice Brennan's language is illuminating:

> [T]he relationship between [the federal] claim and the state claim permits the conclusion that the entire action before the court comprises but one constitutional "case." The federal claim must have substance sufficient to confer subject matter jurisdiction on the court. The state and federal claims must derive from a common nucleus of operative fact. But if, considered without regard to their federal or state character, a plaintiff's claims are such that he would ordinarily be expected to try them all in one judicial proceeding, then, assuming substantiality of the federal issues, there is *power* in the federal courts to hear the whole.[112]

The Court recognized that the argument for pendent jurisdiction is very strong where the state claim is closely related to policies that are

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procedures are but a method of admitting the existence of initial failure in the administration of justice." 435 F.2d at 1231. While there is merit to this contention, such a need for remittitur has not yet been conclusively shown and, even if it were, the exercise of restraint by a judge over a jury is merely a fulfillment of the duties of the court and, as such, is not detrimental to the administration of justice.

[110] *See* Comment, *supra* note 103, at 153.

[111] 383 U.S. 715 (1966).

[112] *Id.* at 725 (emphasis in original) (citation and footnotes omitted).

federal in nature, but also noted several instances in which state claims should be dismissed.[113] Thus, the doctrine of pendent jurisdiction rests on "considerations of judicial economy, convenience and fairness to litigants,"[114] and the question of whether jurisdiction of the state claim is properly assumed was considered to be "one which remains open throughout the litigation."[115]

B. Section 28(a) of the 1934 Act[116]

While interrelations between state and federal regulatory actions in the same area raise questions of preemption, it is clear that Congress, choosing not to fully exercise its powers under the commerce clause, did not preclude state regulation of securities.[117]

The availability of punitive damages via pendent jurisdiction depends substantially, as in actions solely under the federal acts, on the interpretation given to section 28(a) of the 1934 Act. In this context, concern has focused upon the language which preserves preexisting rights and remedies and its relation to the "actual damages" limitation.[118] At least one federal court has interpreted the "actual damages" proviso as restricting the amount of damages available under state law claims to the loss actually incurred.[119] Other courts, however, have viewed the two clauses in 28(a) independently, one limiting damages

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[113] State claims should be dismissed if: (1) federal claims are dismissed before trial; (2) the state law issues are the primary concern of the suit; and (3) "reasons independent of jurisdictional considerations" exist which would require separation. *Id.* at 726-27.

The argument for invocation of pendent jurisdiction would seem to be especially forceful in securities litigation, since state and federal laws in this area have essentially the same objectives—the elimination of fraudulent practices from the market place.

[114] *Id.* at 726.

[115] *Id.* at 727.

[116] Section 28(a), quoted in part in note 65 *supra*, is generally referred to as the "savings clause" of the 1934 Act. Section 16 of the 1933 Act is treated in the same manner. Section 16, 15 U.S.C. § 77p (1970) provides: "The rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." Due to the prevalence of actions under section 10(b) and Rule 10b-5 of the 1934 Act and the fact that it is widely accepted that the two Acts are to be treated in pari materia, only section 28(a) will be discussed.

[117] Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 289-90 (1959). An in-depth discussion of the preemption doctrine is beyond the scope of this comment. *See generally* Comment, *The Availability of Variant State Remedies for Pendent State Fraud Claims Actionable Under the Federal Securities Acts*, 47 S. CAL. L. REV. 1213, 1226-34 (1974).

[118] The pertinent language is: "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity . . . ." Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a) (1970).

[119] *See* Schaefer v. First Nat'l Bank, 326 F. Supp. 1186, 1193 (N.D. Ill. 1970).

under the federal acts, and the other expressly saving state law remedies.[120]

Crucial to the availability of punitive damages under pendent jurisdiction is the question whether the holding in *Globus* should be extended to pendent state claims.[121] Such extension is exemplified by *Schaefer v. First National Bank*.[122] In *Schaefer*, plaintiffs brought a class action to redress an alleged conspiracy to manipulate the market for corporate stock. Violations of federal securities laws and antitrust laws and common law fraud were alleged. The court, relying on *Green* and *Globus*, summarily denied plaintiff's claim for punitive damages under the federal securities acts. In considering the claim for exemplary damages in the common law fraud count, the court held that section 28(a) of the 1934 Act, despite the express reservation of common law remedies, prohibited the recovery of an amount in excess of actual damages.[123] Emphasizing the in pari materia treatment accorded the acts, the court concluded that "punitive damages may not be recovered under common law doctrines for *conduct actionable* under the Securities Acts counts."[124]

The logic supporting this holding is certainly questionable. The limitation of section 28(a) to the recovery of single damages is consistent with the prevailing theory that the section precludes "double recovery."[125] The award of punitive damages does not, however, result in such double recovery. Punitive damages under a common law count and actual damages under the federal provisions constitute a single award of damages on different grounds; a punitive award would be in addition to compensation rather than a duplication. The court appears to have made an unnecessary distinction between "damages" and "remedies." Its reading of 28(a) was in this regard, somewhat incongruous: The court stated that common law remedies were preserved but nevertheless proceeded to deny a traditional common law remedy—punitive damages. Thus, the *Schaefer* decision results in the destruction, not the preservation, of a common law remedy.

It should be noted, however, that policy considerations have played a large role in decisions of this nature. Viewed in this light, *Schaefer's* extension of *Globus* is consistent with prevailing attitudes in the area.

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[120] *See* Young v. Taylor, 466 F.2d 1239, 1338 (10th Cir. 1972).

[121] The court in *Globus* expressly left open the question of recoverability of punitive damages on a common law count. 418 F.2d at 1286 n.11.

[122] 326 F. Supp. 1186 (N.D. Ill. 1970).

[123] The court stated: "Although common law remedies are expressly preserved, the conclusion is unavoidable that common law damages rules permitting recovery in excess of actual damages have not been saved." *Id.* at 1193.

[124] *Id.* (emphasis added).

[125] See text accompanying note 66 *supra*.

Even though a pendent state claim is joined, the action is still based primarily on violations of federal securities laws. Yet the consideration afforded policy should obscure neither the basic fulfillment of statutory purpose nor the rights of states to enforce securities regulations.[126]

Nevertheless, the "prevailing view" approves the recovery of punitive damages under pendent state claims. The primary motivation behind this position appears to be the courts' desire to effectuate what they deem to be the statutory purpose of section 28(a)—the preservation of existing remedies.

The Tenth Circuit, in *Young v. Taylor*,[127] was the first federal circuit court of appeals to extensively treat this issue. In that case, the plaintiffs alleged violations of the federal and state securities laws and common law fraud. The trial resulted in the plaintiffs' recovery of compensatory and punitive damages.

Upholding the exemplary award, the Tenth Circuit carefully considered the purposes underlying section 28(a). Finding little concrete guidance in earlier decisions[128] or in the section's legislative history, the court adopted a strict construction of section 28(a). This section was deemed to serve two functions: the preservation of state remedies and the placement of a restriction on the amount recoverable. In so construing the statute, the court found that upon adequate presentation of the components of a state claim, punitive damages, in addition to damages granted under the federal securities acts, could be obtained. The court emphasized, however, that actual damages could not be awarded under the state claim if already recovered in a federal cause of action.[129]

The decision in *Young* stands on more substantial ground than the district court's opinion in *Schaefer*. The Tenth Circuit, dealing with a

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[126] In addition to section 28(a), section 18 of the 1933 Act, 15 U.S.C. § 77r (1970), expressly provides:

> Nothing in this subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.

[127] 466 F.2d 1329 (10th Cir. 1972).

The proposition that punitive damages are recoverable under a pendent state claim was first recognized in Gann v. Bernzomatic 262 F. Supp. 301, 304 (S.D.N.Y. 1966). In *Gann*, 171 plaintiffs brought an action alleging violations of the 1934 Act and common law principles of fraud and deceit. Defendants contended that punitive damages were not available under the 1934 Act. The court, conceding that this contention may be true, emphasized that the plaintiffs' complaint contained allegations of fraud and deceit under state law. Feeling that this was a claim over which it had pendent jurisdiction, the court, in denying defendants' motion to strike, found that plaintiffs could recover punitive damages under New York law upon adequate proof of their claim.

[128] The contrasting positions of *Schaefer* and *Gann* confronted the court; the Tenth Circuit failed to expressly adopt either position. 466 F.2d at 1337-38.

[129] *Id.* at 1338.

statute whose legislative history is admittedly unclear, elected to employ a literal, restrictive interpretation. Furthermore, the decision soundly applies the principle of pendent jurisdiction.[130] The award of punitive damages avoids the presence of a totally inflexible standard, *i.e.*, the denial of exemplary awards in *all* cases actionable under federal securities laws. The decision does, however, circumvent the disallowance of punitive damages in actions under the 1933 and 1934 acts.

The Fifth Circuit, in *Coffee v. Permian Corp.*,[131] expressly adopted the *Young* rationale. The court held that "it is well established" that punitive damages are recoverable in a pendent state claim properly joined with a federal securities act cause of action.[132]

These recent decisions should not lead the prospective plaintiff to believe that obtaining an exemplary award is simply a matter of following the proper procedure. The burden is, of course, upon the plaintiff to *prove* his state law claim. This problem of proof was illustrated in *Pappas v. Moss*,[133] wherein allegations of common law fraud accompanied claims of section 10(b) and Rule 10b-5 violations. In reviewing the common law fraud count, the court demanded that the elements of a fraud and deceit action under applicable state law be proved.[134] The plaintiff's failure to carry this burden resulted in the dismissal of the count. Since the amount recoverable under the 1934 Act was limited to actual damages, no basis for an exemplary award existed.[135]

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[130] See notes 111 through 115 and accompanying text *supra*.

[131] 474 F.2d 1040 (5th Cir. 1973), *cert. denied*, 412 U.S. 920 (1973). Further support for this position is found in Burkhart v. Allson Realty Trust, 363 F. Supp. 1286, 1291-92 (N.D. Ill. 1973); and *In re* Caesars Palace Sec. Litigation, 360 F. Supp. 366, 394 (S.D.N.Y. 1973).

[132] 474 F.2d at 1044.

[133] 257 F. Supp. 345 (D.N.J. 1966), *rev'd on other grounds*, 393 F.2d 865 (3d Cir. 1968).

[134] 257 F. Supp. at 361; see notes 25 through 28 and accompanying text *supra* for a discussion of common law fraud.

[135] *See* 257 F. Supp. at 361-64. Support for this proposition can be drawn from numerous decisions. *See, e.g.*, Coffee v. Permian Corp., 474 F.2d 1040, 1044-45 (5th Cir. 1973)(exemplary award granted only upon clear showing of state law violation); Young v. Taylor, 466 F.2d 1329, 1338 (10th Cir. 1972) (award of punitive damages not barred upon proof of valid state claim); American Bank & Trust Co. v. Varad Shaff Sec. Corp., 335 F. Supp. 1276, 1283 (S.D.N.Y. 1972) (dictum) (proof of allegations of fraud under state law proper justification for punitive damages); Gann v. Bernzomatic Corp., 262 F. Supp. 301, 304 (S.D.N.Y. 1966)(dismissal of complaint containing claims for punitive damages based on state law improper); *cf.* Coffee v. Permian Corp., 474 F.2d 1040, 1045 (5th Cir. 1973) (Clark, J., concurring and dissenting) (failure to properly instruct jury as to state law claims resulting in denial of punitive damages).

IV. *Smith v. Milam*:[136] An Appraisal

A. Rule 10b-5 Liability and Damages

After determining that the district court possessed jurisdiction over the claims involved in *Smith v. Milam*,[137] the opinion embarked on an analysis of Rule 10b-5 and its relation to the facts of the case. The court recognized that Rule 10b-5 was designed to protect all securities purchasers and that a violation of the antifraud provisions occurs when there is a misrepresentation or omission of a material fact.[138] In addition, since the federal courts have not definitively indicated what acts and practices constitute fraud, the court carefully examined the evidence presented in order to fully evaluate the deceptive nature of the defendants' activities. The court determined that the evidence in this case "overwhelmingly" established violations of the federal securities acts, state statutory law, and common law principles.[139]

Focusing upon the issue of damages, the court held that damages under the federal claims must be limited to actual damages. The court noted that punitive damages, though not allowable under the federal acts, may be awarded where appropriate in a pendent state claim. Accordingly, the court awarded punitive damages since they were "clearly justified in this case."[140]

Though the court reached the right result for the right reasons, its opinion is basically devoid of extensive legal reasoning in support of its conclusions of law. This approach, however, could possibly be attributed to the nature of the factual situation presented to the court. The evidence showed gross violations of the duty owed to the plaintiff and the existence of a continuing scheme to defraud. The court may have believed that these facts constituted such a clear violation of Rule 10b-5 that a detailed analysis of liability would be unnecessary.[141]

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[136] For a detailed discussion of the facts of this case, see notes 4 through 14 and accompanying text *supra*.

[137] Federal jurisdiction was based on the alleged violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1973). Citing Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), and Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970), the court held that a private action could be maintained under Rule 10b-5. Furthermore, under the authority of United Mine Workers v. Gibbs, 383 U.S. 715 (1966), pendent jurisdiction was recognized over the state claims. Smith v. Milam, Civil No. DC 73-21-K at 10-11 (N.D. Miss., Aug. 12, 1975) (unreported).

[138] The Court defined "materiality" in the following manner: "A fact is considered material if a reasonable investor might have considered it important in making a decision as to whether to invest in a certain security." Smith v. Milam, Civil No. DC 73-21-K, at 11 (N.D. Miss., Aug. 12, 1975) (unreported).

[139] *Id.* at 12-13.

[140] *Id.* at 14.

[141] In *Smith*, the court did not attempt to track the literal language of Rule 10b-5 nor

In addition, the court's treatment of the damages issue should not be taken at face value, but instead requires an in-depth analysis. The opinion indicates that the concepts involved in the determination of damages—the limitation under the federal acts to actual damages and the allowance of punitive damages where appropriate under pendent state claims—are well-settled, well-established legal principles, yet only one decision[142] was cited to support the proposition that damages under the federal claims are to be limited to actual damages. Furthermore, the court proffered a single, albeit controlling, decision[143] in support of the punitive award. It seems apparent, however, that, in light of the court's absolute language, litigating parties in the Northern District of Mississippi may assume that punitive damages, not allowable under federal law, may be awarded under a pendent state claim.

B. Attorneys' Fees as an Element of Punitive Damages

The court, in making the exemplary award, stated that "[i]n . . . Mississippi . . . exemplary damages, *including attorney's fees*, are recoverable in the case of willful and oppressive misconduct by a tortfeasor."[144] Since attorneys' fees are not generally recoverable in actions under Rule 10b-5,[145] such an exemplary award is highly significant. Punitive damages assume a different character when viewed as a vehicle for the recovery of attorneys' fees.

The overwhelming majority of jurisdictions subscribe to the American rule regarding attorneys' fees.[146] Under this rule, each litigant, ab-

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did it specifically consider some of the factors often deemed relevant in judicial interpretations. These factors would include: (1) Is plaintiff a purchaser or seller? Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952); (2) scienter of defendant, Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976); White v. Abrams, 495 F.2d 724, 730-35 (9th Cir. 1974); Lanza v. Drexel & Co., 479 F.2d 1277, 1301-06 (2d Cir. 1973); (3) reliance on the misrepresentation, Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972); Blackie v. Barrack, 524 F.2d 891, 905-08 (9th Cir. 1975); and (4) privity, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 101 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). The court, however, did specifically mention the concepts of a right to a private cause of action under 10b-5 and materiality. Smith v. Milam, Civil No. DC 73-21-K, at 11 (N.D. Miss., Aug. 12, 1975) (unreported). Furthermore, though the omitted factors were not distinctly treated, the court's consideration of them could be inferred from its extensive treatment of the facts.

[142] Young v. Taylor, 466 F.2d 1329 (10th Cir. 1972).

[143] Coffee v. Permian Corp., 474 F.2d 1040 (5th Cir. 1973).

[144] Smith v. Milam, Civil No. DC 73-21-K, at 14 (N.D. Miss., Aug. 12, 1975) (unreported).

[145] Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 106 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). *But see* Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970) (attorneys' fees may be awarded in class action under Rule 10b-5).

[146] Actually, every state except Alaska basically follows this rule. Comment, *The Discretionary Award of Attorney's Fees by the Federal Courts: Selective Deviation From*

sent controlling statute to the contrary, must pay his own attorneys' fees regardless of the outcome of the litigation.[147] In addition to the statutory exception, two other exceptions to the prevailing rule have been recognized: Fees have been granted (1) where parties have acted maliciously or in bad faith, and (2) where a fund is created by the prosecuting litigant for the benefit of others.[148]

Since Rule 10b-5 contains no explicit statutory exception,[149] and assuming that a class action is not properly maintainable,[150] punitive damages apparently provide the only means for the recovery of attorneys' fees in Rule 10b-5 actions joined with pendent state claims. This alternative, according to the instant opinion, is available to litigants in Mississippi. The court's conclusion, though not specifically documented,[151] is well-founded since the Mississippi Supreme Court has held that attorneys' fees may be awarded in cases where punitive damages are appropriate.[152]

Inclusion of attorneys' fees as an element of punitive damages, as in *Smith*, can be considered a means of effectuating securities law enforcement. If three factors—no statutory authorization, no class action, and a relatively small prospective recovery—coexist, there will be little, if any, incentive for the plaintiff to bring a Rule 10b-5 action unless the possibility of an exemplary award is present. In essence, the possibility of an out-of-pocket loss deters injured persons from bringing such suits and thereby dilutes the effectiveness of the regulatory scheme.

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the No-Fee Rule and the Regrettably Brief Life of the Private Attorney General Doctrine, 36 OHIO ST. L.J. 588, 588 n.6 (1975).

[147] 43 MISS. L.J. 238 (1972).

[148] Comment, *supra* note 146, at 601-06; *see* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 389-97 (1970). We recognize also the "private attorney general" exception to the American rule, but discussion of that exception is beyond the scope of this comment. For an in-depth treatment of the "private attorney general" exception, see Comment, *supra* note 146, at 606-61.

[149] For examples of such express statutory exceptions, see note 46 *supra*.

[150] See Kahan v. Rosentiel, 424 F.2d 161 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970).

[151] The court merely stated its conclusion without citation of any authority. Smith v. Milam, Civil No. D.C. 73-21-K, at 14 (N.D. Miss., Aug. 12, 1975) (unreported).

[152] Yazoo & M.V.R. R. v. Consumers' Ice & Power Co., 109 Miss. 43, 48, 67 So. 657, 658 (1915). The Mississippi Supreme Court has similarly held that in the absence of statutory authorization, attorneys' fees may not be recovered unless the facts would justify the infliction of punitive damages. Cooper v. United States Fidelity & Guar. Co., 186 Miss. 116, 122, 188 So. 6, 7 (1939).

Judge Keady previously recognized this exception in Mid-Continent Tel. Corp. v. Home Tel. Co., 319 F. Supp. 1176, 1200 (N.D. Miss. 1970), where he awarded punitive damages, including attorneys' fees, of $70,000 for malicious interference with contractual obligations.

Conclusion

The availability of punitive damages under the federal securities acts has been an issue marked by ambiguity. Faced with little legislative guidance and conflicting policy considerations, the courts have struggled to strike a proper balance in this controversial area.

Any consideration of exemplary awards necessarily involves a recognition of the basic policies to be furthered through their award—retribution and deterrence. Specific mechanisms for the measurement of damages, supplied by the express liability provisions of the federal securities acts, are deemed sufficient to redress the enumerated violations; consequently, punitive damages are prohibited. The issue in implied civil actions, however, is substantially more complicated. Varying interpretations of section 28(a), its legislative history and purpose, and divergent evaluations of policy factors have precipitated disagreement. Difference of opinion has also been manifested in actions involving both federal and state violations under the doctrine of pendent jurisdiction.

Prevailing trends indicate that exemplary awards are not available under the federal securities acts but are recoverable when a state law claim is properly joined and proved under pendent jurisdiction. Based on the absolute language in *Smith v. Milam*, however, these concepts could be more appropriately termed existing law in Mississippi, as opposed to prevailing trends.

Richard Devon Gamblin
Paul Houston Stephenson III

PRESERVATION OF CONSUMER CLAIMS AND DEFENSES: MILLER'S TALE TOLLED BY FTC (OR IS IT?)

> It is hard, and it becomes each year harder, for counsel to explain convincingly why "the law" requires that a hard-pressed wage-earner who has been bilked by a now-insolvent seller into buying junk masquerading as a television set or a washing machine must pay the full price to a bank or finance company whose own relationship with the fraudulent seller has been intimate, long-continued and profitable.[1]

I. Cut-Off Devices In Consumer Credit Transactions

In the typical credit sales transaction a consumer,[2] relying on the seller's representations, purchases goods by making a small down payment and signing a promissory note or installment sales contract for the balance of the purchase price. The seller, immediately after the sale, sells his contract rights against the consumer to a third party buyer, generally a finance company or a bank. This procedure obligates the consumer to pay the third party holder of his debt instead of the seller.[3] Subsequent to the assignment, however, the consumer often finds that the product is unsatisfactory.[4] If the seller has become insolvent or unavailable, the consumer's quest for relief generally proves fruitless; he is obligated to continue making payments to the third party since various cut-off devices immunize the third party from the consumer's claims and defenses. Thus, the seller's duty to perform is divorced from the consumer's duty to pay.

The most widely used method of eliminating creditor exposure to consumer claims or defenses arising from a credit sale is the discount method.[5] The discount method offers the third party holder two approaches to gain this immunity; in both cases he is the initial creditor. In the first, the seller compels the consumer to enter the commercial

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[1] Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation?*, 60 Cornell L. Rev. 503, 503 (1975), *quoting* Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 Yale L.J. 1057, 1098 (1954).

[2] In the context of this comment, a "consumer" is a natural person who purchases goods or services on credit for noncommercial use. A "seller" is a person who sells or leases, on credit or otherwise, goods or services to consumers. A "creditor" is a purchaser, including a lending institution, of a contract or the lender in a vendor-related transaction. A "vendor-related transaction" occurs where a creditor advances money to a consumer for the purchase of goods from a seller.

[3] A. Andreasen, The Disadvantaged Consumer 190-92 (1975).

[4] For a discussion of the typical problems confronting consumers see W. Magnuson & J. Carper, The Dark Side of the Marketplace (1969).

[5] For a detailed look at consumer financing patterns see Rohner, *supra* note 1, at 506-15.

paper market: the buyer, in exchange for goods, executes a negotiable promissory note.[6] The merchant then discounts[7] the note to a third party financial institution. The creditor's immunity from seller misconduct in this context results from the "holder in due course" doctrine. The source of this doctrine is commonly attributed to the English case of *Miller v. Race*.[8] In an effort to promote the marketability of commercial paper, Lord Mansfield announced that a bona fide purchaser (BFP)[9] of a stolen promissory bearer note would prevail over all claimants to the note including the original owner.[10] The principle of a BFP for value has, since *Miller*, become an axiom of commercial law and has been codified in the Uniform Commercial Code.[11]

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[6] (1) Any writing to be a negotiable instrument within this Article must
(a) be signed by the maker or drawer; and
(b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article; and
(c) be payable on demand or at a definite time; and
(d) be payable to order or to bearer.
(2) A writing which complies with the requirements of this section is . . .
(d) a "note" if it is a promise other than a certificate of deposit.
UNIFORM COMMERCIAL CODE § 3-104 [hereinafter cited as UCC].

[7] The discount procedure is a negotiation under the UCC since
(1) Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary indorsement; if payable to bearer it is negotiated by delivery.
(2) An indorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto as to become a part thereof.
(3) An indorsement is effective for negotiation only when it conveys the entire instrument or any unpaid residue. If it purports to be of less it operates only as a partial assignment.
(4) Words of assignment, condition, waiver, guaranty, limitation or disclaimer of liability and the like accompanying an indorsement do not affect its character as an indorsement.
Id. § 3-202.

[8] 97 Eng. Rep. 398 (K.B. 1758). *Miller* is not the most relevant type of case to cite in discussing preservation of consumer defenses since that case dealt with a title dispute; however, the FTC cites *Miller* as the first articulation of the holder-in-due-course doctrine. 40 Fed. Reg. 53507 (1975). This doctrine is relevant to the preservation of consumer claims and defenses only when the financing device is a negotiable instrument.

[9] In *Miller*, a BFP was defined as a person who paid fair value and was without notice that the instrument was stolen. 97 Eng. Rep. at 398.

[10] *Id.* at 401. A contrary holding would require a holder of a bearer instrument to look beyond the face of the instrument, impeding its negotiability. E. FARNSWORTH & J. HANNOLD, COMMERCIAL LAW 29 (2d. ed. 1968), *citing* 3 & 4 Wm. IV, Ch. 98, § 6.

[11] UCC §§ 3-302, -305. For a detailed history of the development of negotiable instrument law see W. BRITTON, BILLS AND NOTES 1-9 (2d ed. 1961). *See also* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 1-5 (1972);

The Uniform Commercial Code provides that to the extent that a holder of an instrument is a holder in due course (HDC), he takes free from all claims and personal defenses of any party to the instrument with whom the holder has dealt.[12] To receive this protection a third party holder must first show that he is in fact a holder[13] of a negotiable instrument[14] taken for value,[15] in good faith,[16] and without notice[17] of any claim to or defense against the instrument.[18] The purchaser of a consumer's note is, therefore, insulated from seller misconduct, provided he qualifies as a holder in due course.

A variation of the discount method involves the use of "waiver of defense" clauses in the sales contract. This approach is similar to the one outlined above, with the exception that a nonnegotiable installment sales contract is executed by the consumer.[19] A third party assignee of the contract will obtain protection similar to that given a holder in due course because a typical waiver of defense clause precludes the consumer from asserting, as against a third party assignee, any defenses

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Schnader, *A Short History of the Preparation and Enactment of the Uniform Commercial Code*, 22 U. MIAMI L. REV. 1 (1967).

[12] UCC § 3-305. Under pre-Code law the defenses from which a holder in due course is immune are described as "personal" defenses, a category defined by exclusion. The so-called "real defenses"—the ones to which even a holder in due course takes subject—are enumerated in section 3-305(2). All other defenses are "personal" and include breach of warranty, failure or lack of consideration, unconscionability, and fraud in the inducement. *See generally* J. WHITE & R. SUMMERS, *supra* note 11, at § 14-10.

[13] UCC § 1-201 (20) provides: " 'Holder' means a person who is in possession of . . . an instrument . . . issued or indorsed to him or to his order or to bearer or in blank."

[14] *See id.* § 3-104.

[15] *Id.* § 3-303(a) provides:

A holder takes the instrument for value

(a) to the extent that the agreed consideration has been performed . . . or

(b) when he takes the instrument in payment of or as security for an antecedent claim against any person whether or not the claim is due; or

(c) when he gives a negotiable instrument for it or makes an irrevocable commitment to a third person.

[16] *Id.* § 1-201 (19) provides: " 'Good faith' means honesty in fact in the conduct or transaction concerned."

[17] *Id.* § 1-201 (25) provides:

A person has "notice" of a fact when

(a) he has actual knowledge of it; or

(b) he has received a notice or notification of it, or

(c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

[18] *Id.* § 3-302. To be a holder in due course one must also show that he took the instrument without notice that it was overdue or that it had been dishonored. *Id.* § 3-302(1)(c).

[19] The typical installment sales contract is not a negotiable instrument, though it is possible for one to possess the elements of negotiability pursuant to section 3-104 of the Code.

which might be available against the seller.[20] Section 9-206 of the Uniform Commercial Code protects innocent purchasers of nonnegotiable contracts containing waiver of defense clauses but leaves the purchaser vulnerable to the same real defenses to which a holder in due course is subject.[21] Although this protection is also "subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods,"[22] many states have not established any comprehensive exceptions to section 9-206 protection.[23] Thus, in these states, either approach under the discount method leads to the same result: the consumer's duty to pay is separated from the seller's duty to perform.

The restrictions placed on the discount method in many other jurisdictions[24] have forced creditors to find other means of insulating themselves from claims and defenses of consumers. One of these is vendor-related financing.[25] Using this method a seller structures the sale as two different transactions—as a consumer sales transaction and as a direct loan. In this situation, upon the buyer's request for credit, the seller refers the buyer to a loan outlet, which is formally or informally affiliated with the seller.[26] Quite often the seller even accompanies the buyer and remains present during the loan processing.[27] In any event, the seller succeeds in creating the appearance of two transactions to circumvent the restrictions imposed on the discount method.[28]

In response to widespread dissatisfaction with the immunity accorded third party creditors in consumer transactions,[29] several courts

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[20] CONSUMER CREDIT IN THE UNITED STATES, REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE 34-35 (1972) [hereinafter cited as NCCF REPORT].

[21] UCC § 9-206(1) provides in relevant part:

> Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods, an agreement by a buyer or lessee that he will not assert against an assignee any claim or defense which he may have against the seller or lessor is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3).

[22] *Id. See generally* J. WHITE & R. SUMMERS, *supra* note 11, at § 4-6. This protection is subject to another condition: Since article 9 is applicable to security interests, *see* UCC § 9-102, section 9-206 is not applicable where the seller retains no security interest in the goods he sells under the installment sales contract. *See, e.g.*, Bruce Lincoln-Mercury, Inc. v. Universal C.I.T. Credit Corp., 325 F.2d 2, 19 (3d Cir. 1963).

[23] *See* notes 29 through 37 and accompanying text *infra*.

[24] *Id.*

[25] This arrangement is also called an "interlocking loan." See Rohner, *supra* note 1, at 508. *See also* 40 Fed. Reg. 53514-16 (1975).

[26] 40 Fed. Reg. 53514-16 (1975). *See also* text accompanying notes 60 through 68 *infra*.

[27] This practice is referred to as "body dragging." See 40 Fed. Reg. 53508 (1975).

[28] *See* Note, *Direct Loan Financing of Consumer Purchases*, 85 HARV. L. REV. 1409 (1972).

[29] *See* Countryman, *The Holder in Due Course and Other Anachronisms in Consumer*

have made it increasingly difficult for holders of consumer paper to assert HDC status. Thus, a finance company has been denied HDC status where it had such an active part in underlying sales transactions that it could be regarded as an original party.[30] Lending institutions have also been denied HDC status where the seller is found to be an agent of the institution.[31] Indeed, many courts have gone so far as to hold waiver of defense clauses void as against public policy.[32]

Legislatures have also inhibited the use of cut-off devices in consumer transactions. A prerequisite to claiming HDC status is the use of a negotiable instrument.[33] Thus, HDC status has been denied by statutes prohibiting the use of negotiable instruments in retail installment sales.[34] Restrictions have not been limited to HDC status. Some states have also prohibited the use of waiver of defense clauses in consumer installment contracts.[35] Other states have prohibited the use of these

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Credit, 52 TEXAS L. REV. 1 (1973); Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 S. CAL. L. REV. 48 (1966); Littlefield, *Preservation of Consumer Defenses in Interlocking Loans and Credit Card Transactions—Recent Statutes, Policies, and a Proposal*, 1973 WIS. L. REV. 471; Murphy, *Another "Assault Upon the Citadel": Limiting the Use of Negotiable Notes and Waiver-of-Defense Clauses in Consumer Sales*, 29 OHIO ST. L.J. 667 (1968); Rosenthal, *Negotiability—Who Needs It?*, 71 COLUM. L. REV. 375 (1971); 43 MISS. L.J. 228 (1972).

[30] *See, e.g.*, Swanson v. Commercial Acceptance Corp., 381 F.2d 296 (9th Cir. 1967); Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940); Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950); Jones v. Approved Bancredit Corp., 256 A.2d 739 (Del. 1969); Mutual Fin. Co. v. Martin, 63 So. 2d 649 (Fla. 1953); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967); American Plan Corp. v. Woods, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968). *Contra*, Waterbury Sav. Bank v. Jaroszewski, 238 A.2d 446 (Cir. Ct. Conn. 1967); Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W.2d 657 (1954).

[31] *See, e.g.*, Palmer v. Associates Discount Corp., 124 F.2d 225 (D.C. Cir. 1941); Calvert Credit Corp. v. Williams, 244 A.2d 494 (D.C. Ct. App. 1968); Westfield Inv. Co. v. Fellers, 74 N.J. Super. 575, 181 A.2d 809 (1962); State Nat'l Bank v. Cantrell, 47 N.M. 389, 143 P.2d 592 (1943).

[32] *See, e.g.*, Fairfield Credit Corp. v. Donnelly, 158 Conn. 543, 264 A.2d 547 (1969); Quality Fin. Co. v. Hurley, 337 Mass. 150, 148 N.E.2d 385 (1958); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967).

[33] The HDC requirements, section 3-302, are applicable only to commercial paper. *See* UCC § 3-103, Comment 1.

[34] *See* CAL. CIV. CODE § 1810.7 (West Supp. 1971); MASS. GEN. LAWS ANN. ch. 255, § 12 C (Supp. 1972); N.Y. PERS. PROP. LAW § 403(1) (McKinney 1971); UTAH CODE ANN. § 70B-2-404 (Supp. 1971); VERMONT STAT. ANN. tit. 9, § 2455 (1969). *See also* N.H. REV. STAT. ANN. §§ 320:21-a, -b(Supp. 1971) (limited to home solicitation sales); WASH. REV. CODE ANN. § 63.14.020 (1968). *See generally* J. WHITE & R. SUMMERS, *supra* note 11, at § 14-9.

[35] *See, e.g.*, ALASKA STAT. § 45.10.140 (1962); CAL. CIV. CODE § 1804.2 (West Supp. 1971); HAWAII REV. STAT. § 476-18(5)(d)(1968); MASS. GEN. LAWS ANN. ch. 255D, §§ 10(6), 25A (Supp. 1976-77). *See also* CAL. CIV. CODE § 1804.2 (West Supp. 1971).

clauses in specific areas of the consumer credit market.[36] In addition, several states statutorily provide for a delay period before a lender can claim immunity from the buyer's claims and defenses.[37]

The protection afforded the consumer in these jurisdictions reflects a policy decision with regard to the allocation of the cost of the seller's misconduct. It has been suggested that this policy decision is directed toward two goals: (1) minimization of the cost to innocent parties; and (2) implementation of the theory that the cost of minimizing seller misconduct should be regarded as part of the social cost of the consumer goods distribution system and should be reflected in the cost of consumer goods.[38] This is best achieved by placing the risk of seller misconduct on the financial institution since it is in a superior position to return the cost of the seller's misconduct to the seller. The creditor also has the facilities the consumer lacks to investigate the seller's reliability.[39]

Although local attempts have been made to deal with creditor immunity from consumer claims and defenses, these efforts have been piecemeal.[40] The Federal Trade Commission (FTC), on the other hand, has dealt with the problem on a larger scale. Pursuant to its statutory authority,[41] it has promulgated a rule preserving consumers' claims and defenses in credit sales transactions[42] despite the possibility that these restrictions may have the effect of limiting the supply and increasing the cost of consumer credit.[43]

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[36] *See, e.g.*, MISS. CODE ANN. § 63-19-41 (1972)(prohibits all cut-off devices in motor vehicle retail installment sales); NEV. REV. STAT. ch. 97.275 (1967)(prohibits waiver of defense clauses); ORE. REV. STAT. § 83.150 (1971)(prohibits waivers in all retail installment contracts of goods except motor vehicles); PA. STAT. ANN. tit. 69, §§ 6151(f), (g) (Purdon 1965) (prohibits use of negotiable notes or waivers in retail installment sales of motor vehicles); WASH. REV. CODE ANN. § 63.14.150 (Supp. 1975)(prohibits waivers in retail installment sales contracts).

[37] *See, e.g.*, DEL. CODE ANN. tit. 6, § 4312 (Supp. 1974)(15 day period); ILL. ANN. STAT. ch. 121 ½, § 262D (Smith-Hurd Supp. 1975) (5 day period); PA. STAT. ANN. tit. 69, § 1402 (Purdon Supp. 1976-77) (45 days for all retail installment sales contracts); TEX. REV. CIV. STAT. ANN. arts. 5069-6.07 to -7.08 (Vernon Supp. 1970)(30 days notification for all retail installment sales).

[38] *See* Note, *supra* note 28, at 1411-14. When consumer prices approximate real social costs, society's resources are most efficiently allocated. C. FERGUSON, MICROECONOMIC THEORY 391-92 (1966).

[39] *See* Comment, *Translating Sympathy for Deceived Consumers Into Effective Programs for Protection*, 114 U. PA. L. REV. 395 (1966).

[40] 40 Fed. Reg. 53521, 53522 nn.55 through 59 (1975).

[41] 15 U.S.C. §§ 41 *et seq.* (1970), as amended.

[42] 16 C.F.R. §§ 433.1, -.2 (1975) (effective as of May 14, 1976).

[43] 40 Fed. Reg. 53517 (1975); 36 Fed. Reg. 1211 (1971). *See also* Rohner, *The FTC Does Lord Mansfield In*, 62 A.B.A.J. 372 (1976).

The argument that creditors need holder in due course protection to keep costs

II. The Anti-HDC Rule

A. *Preservation of Consumers' Claims and Defenses*

In promulgating section 433.2[44] (anti-HDC rule)[45] the FTC has made it an unfair or deceptive act or practice for a seller to enter into a consumer credit contract[46] or to arrange a vendor-related purchase money contract for a consumer which does not contain the following provision in at least ten point, bold face type:

> **NOTICE**
>
> **ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.**[47]

The main purpose of the new regulation is to prevent the seller in consumer credit sales transactions from divorcing the buyer's obligation to pay for goods and services from the seller's duty to perform.[48] Since the provision is incorporated into the consumer-seller contract, it will also become part of the consumer-creditor agreement when the seller discounts the sales contract.

It appears that the provision may not be qualified in any way by other terms of the contract; such a qualification would undermine the rule's purpose.[49] If a consumer credit contract contains the anti-HDC

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down and to make credit available was deflated by the commission, which noted also that it might be distinctly good to dry up the sources of credit for the food-freezer rackets, the home improvement swindlers, and the vanishing health spa operators.

The best quoted remark in the record to me is this, by Prof. Homer Kripke of the New York University Law School, himself a longtime finance company lawyer: "The banks ought to be ashamed of arguing that they are serving merchants whose injuries to their customers are so substantial as to constitute a significant impairment of the collectibility of the obligations."

Id. at 373.

[44] 16 C.F.R. § 433.2 (1975).

[45] This term is used only as a shorthand designation of the rule. It should be noted that the rule is aimed not only at the holder in due course doctrine, but also at all cut-off devices through which creditors gain immunity from consumer claims and defenses. 40 Fed. Reg. 53522-23 (1975).

[46] Section 433.2 is limited to *consumer* credit contracts and does not apply to all credit instruments. *See* 16 C.F.R. § 433.1(i)(1975) (defining consumer credit contracts).

[47] *Id.* § 433.2.

[48] 40 Fed. Reg. 53522 (1975).

[49] For a statement of that purpose see *id.*

provision, a waiver of defense clause cannot operate to defeat that provision. The FTC has explicitly manifested its intent to make adhesive contract provisions of this type an unfair and deceptive practice on the part of the seller where the consumer receives no substantial benefits from the relinquishment of his right to assert claims and defenses.[50]

The new FTC regulation assures that the consumer's most effective weapon—stopping payment—is not denied. Under the new rule the consumer may now effectively stop his payments to a third party lender when the seller breaches his contract. Since the anti-HDC provision eliminates the lender's favored status, the consumer can now successfully defend against a creditor's suit based on the consumer's obligation to pay by raising a valid claim against the seller as a defense or set off.[51] The consumer may also bring an affirmative action against the creditor to recover money paid on the account.[52]

The new FTC regulation, however, explicitly limits the creditor's liability[53] by providing that "recovery . . . by the debtor [consumer] shall be limited to amounts paid by the debtor . . . ."[54] Thus, the consumer can assert a right to withhold the balance of a purchase price owed to the creditor, assert a right to an affirmative recovery of money not exceeding the amount the consumer has paid, or both.

B. Transactions Affected by the FTC Regulations

1. Consumer Purchases

In order to come within the new regulation the transaction must first arise "in connection with any sale or lease of goods or services to consumers . . . ."[55] The FTC defines "consumer" as any "natural person who seeks or acquires goods or services for personal, family, or household use."[56] By implication, sales of goods and services for commercial purposes would not be covered by the FTC regulation.[57] Since a consumer must be a natural person, it follows that a corporation or any other business organization is also excluded.

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[50] *Id.* at 53524.

[51] *Id.*

[52] *Id.* This situation can arise when a consumer has made payments to a third party creditor for consumer goods which, because of the seller's misconduct, are never delivered.

[53] This limitation, restricting recovery under the rule, does not explicitly preempt state law from providing additional measures of recovery. *See* 16 C.F.R. § 433.2 (1975).

[54] *Id.*

[55] *Id.*

[56] *Id.* § 433.1(b).

[57] Farm machinery and equipment would probably fall under this same exclusion as commercial activity. Although pure conjecture, this conclusion seems reasonable since state laws uniformly recognize the distinction between consumer goods and farm equipment. *See* UCC §§ 9-109(1), -(2).

2. Discount Transactions

The regulation is desinged to reach consumer credit transactions which are subject to the greatest abuse by third party cut-off devices. The anti-HDC rule reaches the discount method, encompassing both the use of negotiable and nonnegotiable contracts, by concentrating upon the source of the consumer paper—the seller. A seller is "a person who, in the ordinary course of business, sells or leases goods or services to consumers."[58] A seller may not accept the proceeds of a consumer credit contract which does not contain the required clause. A consumer credit contract is "any instrument which evidences or embodies a debt arising from a 'Purchase Money Loan' transaction or a 'financed sale' as defined . . ." in the rule.[59]

3. Vendor-Related Loans

Vendor-related loans are characterized by the seller and the creditor working together and the creditor having firsthand knowledge of the business practices of the seller. Because vendor-related financing is an attractive alternative to the discount method, an attempt to restrict discount financing alone would encourage the use of vendor-related financing and thus make avoidance of the anti-HDC rule both easy and inevitable.[60]

The FTC has chosen to include vendor-related loans within the anti-HDC rule's coverage since repeated dealings with the seller put the creditor in a position to ascertain whether the seller is likely to misbehave. The creditor is, therefore, better able to allocate the risk of seller misconduct. The FTC has chosen, however, to leave direct loan financing unregulated where no relation between the seller and the lender exists.[61]

The anti-HDC regulation is restricted in its effect to purchase money loans.[62] The FTC defines a purchase money loan as

> [a] cash advance which is received by a consumer in return for a "Finance Charge" within the meaning of the Truth in Lending Act and Regulation Z, which is applied in whole or substantial part, to a purchase of goods or services from a seller who (1) refers consumers to the creditor or (2) is affiliated with the creditor by common control, contract or business arrangement.[63]

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[58] 16 C.F.R. § 433.1(j)(1975).

[59] *Id.* § 433.1(i).

[60] 40 Fed. Reg. 53515 (1975).

[61] Genuine "direct loans" are excluded from the rule by the definition of "Purchase Money Loan." *See* text accompanying note 63 *infra*.

[62] 16 C.F.R. § 433.2(b)(1975).

[63] *Id.* § 433.1(d).

The effect of this provision is to exempt loan transactions in which a seller plays no role and to regulate only those loans which, in whole or in substantial part, are to be applied to the purchase from a vendor-related merchant. The "substantial" requirement prevents a lender from extending additional nominal credit for the purpose of defeating the regulation.

This part of the regulation also provides a two-bladed test for determining whether a direct loan is vendor-related. The rule first covers consumer credit contracts where consumers are referred to a finance company by the seller.[64] The FTC did not establish what constitutes a referral, nor did it establish how many referrals are necessary to invoke the rule.[65] These questions must be answered by the courts.[66] It is consistent with the purpose of the regulation to interpret referrals as those situations where a seller in the ordinary course of his business refers the buyer to a particular financer or class of financers on a regular basis.

The second half of the test is structured to reach those sellers who are "affiliated" with the creditors by common control, contract, or business arrangement.[67] These types of affiliation are generally defined to reach those sellers and creditors who are separate institutions in form, but who in substance maintain close, cooperative relations on a continuing basis.

This two point test is a refinement of the rule's second proposed version which contained nine specified fact situations indicative of a cooperative arrangement between seller and creditor.[68] The Commission stated that this refinement encompasses all those situations enumerated in the earlier proposed version, with the exception of the ninth, which

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[64] *Id.* § 433.1(d)(1).

[65] Presumably more than one referral is required to bring a transaction within the rule's definition of "Purchase Money Loan" because this definition uses the plural form: "(a) refers *consumers* to the creditor," 40 Fed. Reg. 53525 (1975)(emphasis added). The Commission refused to adopt a specific number of referrals since "such a number would be arbitrary." *Id. See also* notes 62 through 69 and accompanying text.

[66] "Some litigation will be needed to flesh out the meaning of parts of the rule . . . . When, for example does a seller 'refer customers to the creditor'?" Rohner, *supra* note 43, at 373.

[67] 16 C.F.R. § 433.1(d)(2)(1975).

[68] These fact situations are: (1) relation by blood or marriage between seller and creditor; (2) and (3) relation due to preparation of forms used in processing credit; (4) common control or affiliation of seller and creditor; (5) joint ventures; (6) payment of consideration by creditor to seller; (7) guarantee of loan by seller; (8) five or more loans; (9) relation by knowledge of seller misconduct. 40 Fed. Reg. 53515 (1975). These factors are similar to those discussed in cases where creditors are denied HDC status because of their "close-connectedness" with sellers. *See* J. WHITE & R. SUMMERS, *supra* note 11, at § 14-8.

involved knowledge of seller reputation.[69] This situation was exempted because the Commission was

> not persuaded that knowledge alone suggests a course of dealing, even though questions of a creditor's knowledge are relevant to a determination of his relationship with a seller. Such a test should not be dispositive. It raises too many problems of proof.[70]

The nine situations in the earlier rule created rebuttable presumptions that a creditor was sufficiently involved with a seller to warrant imposition of the rule.[71] The present rule contains no rebuttable presumptions.[72] Operation of the rule turns on the definitions of "Purchase Money Loan," "Contract," and "Business Arrangement."[73] It is fortunate that the Commission adopted this latter approach because the "laundry list of connective presumptions between a seller and a lender"[74] would "tend to hamstring enforcement efforts with endless factual disputes about the extent and nature of the relationship."[75]

4. Credit Card Transactions

The FTC explicitly excluded credit card issuers[76] from the mandate of the new regulation.[77] The use of a credit card is quite similar to an installment sales transaction. The master contract under which a credit card is issued usually contains a waiver of defense clause.[78] If a consumer unknowingly purchases a product from a nonperforming merchant by using a credit card, he is nevertheless obligated to pay the credit card

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[69] 40 Fed. Reg. 53525 (1975). The deemphasis is illogical since the Commission excluded the "five or more loans" set forth in the eight situations. *See id*; note 65 *supra*.

[70] 40 Fed. Reg. 53525 (1975).

[71] *Id.*

[72] *See id.*

[73] *Id.*

[74] Rohner, *supra* note 43, at 373.

[75] *Id.*

[76] A credit card issuer is defined as "[a] person who extends to cardholders the right to use a credit card in connection with purchases of goods or services." 16 C.F.R. § 433.1(h)(1975).

[77] A creditor is defined as

> [a] person who, in the ordinary course of business, lends purchase money or finances the sale of goods or services to consumers on a deferred payment basis; *Provided, such person is not acting,* for the purpose of a particular transaction, *in the capacity of a credit card issuer.*

Id. § 433.1(c) (emphasis added).

[78] 40 Fed. Reg. 53516 (1975). There are over 275 million credit cards currently held by American consumers. Of these, 5 million travel and entertainment cards and 55 million bank-issued cards were issued under a waiver of defense clause. *Id.; see* Ross, *The Credit Card's Painful Coming of Age,* FORTUNE, October 1971, at 108.

issuer. Those in favor of including credit card issuers within the new FTC regulation have argued that it is a potential area of abuse and that the waivers are contracts of adhesion and against public policy.[79] Opponents of their inclusion have argued that credit card transactions are uniquely different from those controlled by the regulation in that the credit card waivers are not abused and that a ban on the waivers would interfere with modern automated financing.[80] The FTC found little abuse in this area and also found adequate protection already provided to consumers.[81]

5. "Affecting" Commerce

The anti-HDC rule is applicable only to those transactions within FTC jurisdiction. Prior to the Magnuson-Moss Amendments to the Federal Trade Commission Act (FTCA),[82] judicial interpretation did not allow FTC control of those unfair acts which only "affected" interstate commerce,[83] thereby severely limiting the FTC's jurisdiction. The Magnuson-Moss Amendment, by adding the words "in or affecting" to the FTCA, will

> allow the Commission to regulate wholly instrastate or purely local activities as long as they affect interstate commerce. Local consumer abuses where state programs are nonexistent and fly-by-night operators who conduct their business entirely within one state and then move on to the next before local officials are informed of their activities will now be within the Commission's jurisdiction.[84]

As a result of this jurisdictional expansion, it is now possible for the FTC to preempt state and local agencies in combatting consumer fraud, although the Senate and House indicated that this is not the intent of the amendment.[85]

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[79] 40 Fed. Reg. 53516 (1975).

[80] *Id.*

[81] *Id.* The Fair Credit Billing Act invalidates waiver of defense clauses in credit card contracts where a card is used to make a purchase of more than 50 dollars within the state where the user lives or within 100 miles of the place where the card is issued. 15 U.S.C. § 1666j (Supp. IV, 1974).

[82] Magnuson-Moss Warranty—Federal Trade Commission Improvement Act, Pub. L. No. 93-637 (Jan. 4, 1975), *codified in* 15 U.S.C.A. §§ 45, 46, 56, 57 (Supp. 1976) [hereinafter cited as Magnuson-Moss Amendment].

[83] FTC v. Bunte Bros., Inc., 312 U.S. 349 (1941).

[84] Note, *The Magnuson-Moss Amendments to the Federal Trade Commission Act: Improvements or Broken Promises?*, 61 Iowa L. Rev. 222, 231 (1975).

[85] *See* Senate Comm. on Commerce, S. Rep. No. 151, 93d Cong., 1st Sess. 27 (1973); House Comm. on Interstate and Foreign Commerce, Consumer Product Warranties and Federal Trade Improvement Act, H. R. Rep. No. 1107, 93d Cong., 2d Sess. 29-30 (1974).

> The FTC is to act only if state enforcement is deficient; it should be emphasized though, that it is the FTC, not the state or local agency, which determines whether the state's consumer protection program is effective. In short, even though the Commission's enlarged jurisdiction was not intended to occupy the field, the likelihood of some preemption still exists.[86]

III. Enforcement of the Anti-HDC Rule

Enforcement difficulties arise if a seller does not comply with the anti-HDC rule, *i.e.*, if he initiates consumer contracts or accepts the proceeds of vendor-related purchase money loans which do not contain the required provision. Failures to comply can surely be anticipated; sellers who engage in fraudulent and deceptive practices will seldom be reluctant to add another infraction to their list of misdeeds. Moreover, it is unlikely that consumers will be able to prevent such conduct; it is generally conceded that the consumer population for whose benefit the anti-HDC rule was written is a commercially unsophisticated group.[87]

When a creditor makes demand for payment under a contract which does not contain the anti-HDC provision, and which has been breached by the seller, the consumer has four choices: (1) seek a private remedy against the seller; (2) seek FTC action against the seller; (3) seek a private remedy against the creditor; (4) seek FTC action against the creditor. The third approach includes both an affirmative action on the contract by the consumer and the consumer's defense to an action by the creditor for nonpayment of the debt.

The consumer who pursues a remedy under most of these approaches will find little aid in the anti-HDC rule. Several reasons compel this conclusion. First, litigation is expensive. Second, a violation of the anti-HDC rule raised as a claim or defense fits poorly into the traditional remedy theories of contract law. Third, the FTC is a "ponderous"[88] agency of "suspect"[89] efficacy in protecting consumers. Fourth, the anti-HDC rule imposes no duties upon creditors.[90]

A. Private Action Against Seller

Private actions by the consumer against the seller are often fruitless. The rule was proposed partially because of this difficulty:

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[86] Note, *supra* note 84, at 231.

[87] *See* A. Andreasen, *supra* note 3, at 186-88. Additionally, "many consumers simply fail to read their contracts." 40 Fed. Reg. 53525 (1975). *See generally* Countryman, *supra* note 29, at 2-11.

[88] Guernsey v. Rich Plan of the Midwest, 408 F. Supp. 582, 588 (N.D. Ind. 1976).

[89] *Id.* at 586.

[90] The rule is written wholly in terms of a seller's duty. *See* 16 C.F.R. §§ 433.1, -.2 (1975).

> [T]he worst sellers are likely to be the most volatile entities where market tenure is concerned. They prove difficult to locate and serve, and the marginal liquidity which characterizes their operations makes collection of a judgment difficult or impossible even if they are successfully served. Bankruptcy or insolvency becomes a final barrier to recovery.[91]

The elusive nature and judgment proof characteristics of unscrupulous sellers are well documented. For example, one operator dismantled a computer school overnight and disappeared, owing 21 students about $2,000 each for training which they had not received.[92] Once located, such merchants are difficult to serve with legal process,[93] and even when brought to justice, they frequently resurface with similar schemes, changing only the name of their operation.[94]

Additionally, a victimized consumer must face the economic realities of litigation. Most consumer claims are so small that only out of principle will a private attorney take the case.[95] "As a result, the wronged consumer's most appropriate advocate, the private bar, is put at a severe and unnecessary disadvantage."[96] Empirical study verifies this common sense observation.[97] Attempts to make private consumer redress more economical have met with limited success; in fact, it has been charged that some small claims courts make it easy for merchants to obtain judgments against consumers, but do little to aid the consumers against the merchant.[98]

B. FTC Action Against Seller

The problems which the consumer faces in obtaining private relief from those who defraud him are matched by the difficulties he faces

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[91] 40 Fed. Reg. 53512 (1975).

[92] *Id.* at 53513 n.11.

[93] Thus, two attorneys, employed by the New York Department of Consumer Affairs, were temporarily imprisoned and threatened when they attempted to serve a subpoena on an illicit television repairman. They were successful on a later attempt only with police aid. *Id.* at 1535-47.

[94] *See* Schrag, *On Her Majesty's Secret Service: Protecting the Consumer in New York City,* 80 YALE L.J. 1529 (1971). A merchant, selling bogus educational material, had agreed in a court settlement with the New York Attorney General not to falsely describe the sales jobs for which his company sought applicants. Scarcely a year later the scoundrel was engaged in the same kind of operation under a different name. *Id.* at 1590-91.

[95] *See* Eckhardt, *Consumer Class Actions,* 45 NOTRE DAME LAW. 663 (1970).

[96] *Id.* at 663.

[97] *See* Comment, *supra* note 39. A University of Pennsylvania study of consumer claims under the state's usury laws concluded that "[t]he number of consumers having no redress because the amount lost is not commensurate with the attorney's fee constitutes the vast majority." *Id.* at 409.

[98] *Id.* at 436.

should he decide to rely upon the aid of the FTC. Although the Commission is the agency primarily responsible for consumer protection,[99] it has largely failed in that mission.[100]

This failure is well documented.[101] All the critics of the FTC have arrived at essentially the same conclusion:

> The Commission is rudderless; poorly managed and poorly staffed; obsessed with trivia; politicized; all in all, inefficient and incompetent. And—the persistence of these criticisms would seem to indicate—[the Commission is] largely impervious to criticism.[102]

These conclusions are well summarized by the four findings of *The Nader Report on the Federal Trade Commission.* The FTC has failed to: (1) "detect violations systematically";[103] (2) "establish efficient priorities for its enforcement energy";[104] (3) "enforce the powers it has with energy and speed";[105] and (4) "seek sufficient statutory authority

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[99] E. Cox, R. Fellmeth & J. Schulz, The Nader Report on the Federal Trade Commission vii (1969) [hereinafter cited as Nader Report].

[100] Report of the ABA Commission to Study the Federal Trade Commission 191 (1969).

[101] *See, e.g.*, Commission on Organization of the Executive Branch of the Government, Task Force on Regulatory Commissions, Appendix N. 119-33 (1949); G. Henderson, The Federal Trade Commission: A Study in Administrative Law and Procedure (1924); J. Landis, Report on Regulatory Agencies to the President-Elect (1960); Auerbach, *The Federal Trade Commission: Internal Organization and Procedure*, 48 Minn. L. Rev. 383 (1964).

[102] Posner, *The Federal Trade Commission*, 37 U. Chi. L. Rev. 47, 47 (1969).

[103] Nader Report, *supra* note 99, at 39. The Commission's primary mode of detecting consumer fraud is "mailbag notice." *Id.* Consumers notify the Commission only through "application for complaint." This source is insufficient because those consumers who are aware of the FTC are also aware of the "historic futility" of appealing to the Commission. To illustrate this futility the report points out that of the 9,000 complaints received in 1969, only 11 percent were investigated and only 3 percent resulted in FTC corrective action. *Id.* at Appendix 6. Also, in the ghettos where consumer fraud is especially severe, "the consumers don't know a thing about the FTC." *Id.* at 40. *See generally* A. Andreason, *supra* note 3.

[104] Nader Report, *supra* note 99, at 39. This lack of priorities has resulted in a disproportionate level of FTC action in the immediate area of Washington, D.C. This concentration results from the inadequacy of the FTC's detection effort outside the Washington area and the Commission's overly responsive attitude toward problems presented by Congressmen. *Id.* at 43-44. This "first things last" priority system is also due to the Commission's fear of large corporations' legal staffs coupled with the pressure exerted on Congress through the companies' lobbying efforts. *Id.* at 57.

[105] *Id.* at 39. Since the early 1970's the FTC enforcement effort has declined significantly, *id.* at Appendix 4, brought about largely as a result of greater reliance on voluntary enforcement tools. *Id.* at 39. In enforcing its consumer protection provisions the Commission has been notoriously slow; the average period from complaint to FTC enforcement is 4 years. *See In re* Holland Furnace Co., 341 F.2d 548 (7th Cir.), *cert. denied*, 381 U.S. 924 (1965)(29 years from entry of consent order to imposition of fine); Carter Prod-

to make its work effective."[106]

To remedy this situation, Congress has expanded the enforcement tools available to the FTC, including preliminary injunctive power,[107] and broadened the Commission's substantive rulemaking power.[108] Congress has also given the Commission power to represent itself in most civil actions and to proceed in federal or state court to obtain relief for injured consumers.[109] Whether these measures will significantly improve the FTC or whether they constitute mere "facelifting" is an open question.[110]

C. Consumer-Creditor Litigation

1. The Consumer as Defendant

The legal barriers are formidable where the consumer has financed a purchase by signing a negotiable instrument. In order to successfully defend a creditor's suit on the instrument, he must first establish a defense to the instrument and then defeat the creditor's claim to holder in due course status.

It should be noted that promulgation of the anti-HDC rule has not significantly altered the consumer's economic plight in the defense of an action on a consumer note which does not contain the required anti-HDC provision.[111] The expenses of litigation will still be incurred; however, a new element has been added to the consumer's argument.

That new element is argued as follows: A seller now has a statutory duty to include the anti-HDC clause in consumer contracts.[112] The seller's taking of a negotiable instrument which does not contain the required provision makes the contract between the consumer and the seller illegal, thus establishing a personal defense against the instrument.[113] Since a person is presumed to be cognizant of the law,[114] a

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ucts, Inc. v. FTC, 268 F.2d 461 (9th Cir.), *cert. denied*, 361 U.S. 884 (1959)(16 years to get the "Liver" out of Carter's Little Liver Pills).

[106] NADER REPORT, *supra* note 99, at 39. Prior to the Magnuson-Moss Amendment the only enforcement tool available to the FTC was a cease and desist order followed by a civil penalty if the transgressor did not obey the order. *See* 15 U.S.C. § 45(b)(*l*) (1970). This weapon was not effective in providing consumer remedies because the FTC orders were so frequently disregarded and because a consumer could not get damages through private action.

[107] 15 U.S.C. §§ 53(b)(1), (2) (Supp. III, 1973).

[108] 15 U.S.C.A. §§ 45, 46, 56 (Supp. 1976).

[109] *Id.* at §§ 110(c)(1), 202.

[110] Note, *supra* note 84.

[111] *See generally* 40 Fed. Reg. 53511-12 (1975).

[112] *See* section II. *A. supra.*

[113] *See generally* 6A A. CORBIN, CORBIN ON CONTRACTS § 1374 (1962) [hereinafter cited as CORBIN].

[114] See Fidelity Sav. State Bank v. Grimes, 156 Kan. 196, 131 P.2d 894 (1942).

creditor who knowingly takes a consumer obligation which does not contain the anti-HDC clause has "notice" of the defense within the meaning of the Uniform Commercial Code.[115] Moreover, inasmuch as a person with "notice" of a defense cannot become a holder in due course,[116] the creditor takes the instrument subject to *all* personal defenses—including illegality.[117] Reinforcing this argument is the fact that holders of the instrument have notice of any gross legal defects contained therein.[118] Thus, assuming the creditor has knowledge that this is a consumer contract, the consumer will prevail.

In the defense of a creditor suit for nonpayment of a nonnegotiable instrument containing a waiver of defense clause, the consumer must change both the purpose and content of his illegality argument. Similarly arguing notice of illegality on the part of the transferee, the purpose shifts from a denial of HDC status to a denial of the protection offered by section 9-206.[119] The argument's content differs in that here it is urged that an illegal clause was included rather than that a required clause was excluded. This illegal inclusion establishes the consumer's defense, and, assuming the creditor has "notice" of the defense, the consumer will triumph. Of course, a creditor who takes a nonnegotiable instrument which is not part of a secured transaction so as to be subject to section 9-206, or which does not contain a waiver of defense clause, will be subject to all valid defenses of the consumer.

In vendor-related transactions the consumer has entered into no credit agreement with the seller; his only basis for asserting seller-related defenses against the creditor is the anti-HDC rule. The omission of the required provision is not a good illegality defense, however, because the creditor violated no law by entering into the debt agreement with the consumer. The omission of the anti-HDC clause is equally impotent as a defense against the seller; he is not a party to the debt contract and could not reasonably be held responsible for the omission. A tenuous argument based on a reformation approach is a faint possibility, thus, a successful result would entail the court "reading in" the anti-HDC clause.

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[115] UCC § 1-201(25).

[116] UCC § 3-302(1)(c) provides: "A holder in due course is a holder who takes the instrument . . . without notice . . . of any defense against or claim to it on the part of any person."

[117] UCC § 3-306 states that

> [u]nless he has the rights of a holder in due course any person takes the instrument subject to . . . (b) all defenses of any party which would be available in an action on a simple contract . . . .

[118] HIMC Inv. Co. v. Siciliano, 103 N.J. Super. 22, 246 A.2d 502 (Law Div. 1968); J. WHITE & R. SUMMERS, *supra* note 11, at § 14-6.

[119] UCC § 9-206. See note 21 *supra*.

2. The Consumer as Plaintiff

If the consumer seeks a refund of payments made under a debt instrument which does not contain the mandatory anti-HDC clause, his best approach appears to be based on the theory of restitution. Restitution is designed "to place both of the parties in the position they had prior to entering into the transaction."[120] Thus,

> [t]he court will say that [the] "contract" will not be enforced, but that the plaintiff will be permitted to "rescind" (or to disregard) the contract and will then have a right to his property or money back, or to the reasonable value of a performance rendered by him and received by the defendant.[121]

This basis of recovery should be available since the consumer entered the contract under a material mistake of fact. The seller would have actual knowledge of the anti-HDC rule, while the consumer would not; "and it may be quite reasonable for the latter to rely upon the former with respect to legal requirements. In no such case will the . . . innocent party be deprived of rescinding or restitutionary remedies . . . ."[122] Assuming once again that the creditor has "notice" of the illegality of the contract so as to preclude HDC status, the consumer should be able to trace the funds to the creditor and recover any amounts paid.

D. FTC Action Against the Creditor

The anti-HDC rule imposes no duty upon creditors; the rule is written wholly in terms of what sellers must do when preparing consumer purchase money contracts and when accepting proceeds of vendor-related loans to consumers. The effect of this omission is twofold. First, a creditor may purchase a consumer instrument which does not contain the required clause without breaking the law. Thus, if courts hold that creditors can enforce contracts which violate the anti-HDC rule, creditors will have little incentive to screen the contracts which they purchase. Also, creditors may be inclined to take their chances until the question is settled. This assures the unscrupulous merchant a continued cash market for his suspect consumer paper. Second, this omission denies the consumer access to the expanded statutory scheme of redress provided by the FTCA.[123] Creditors may disregard the anti-HDC rule completely and still not be subject to any of the expanded enforcement tools available to the FTC.

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[120] J. Calamari & J. Perillo, The Law of Contracts § 237 (1970).

[121] 6A Corbin, *supra* note 113, § 1535, at 822.

[122] *Id.* § 1539, at 832.

[123] See note 106 *supra*.

IV. Proposed Change To The Rule

The FTC has proposed that the anti-HDC rule be expanded to include creditors.[124] If adopted, this rule would eliminate many of the enforcement difficulties discussed above. By imposing a duty upon creditors, the FTC would assure that dishonest sellers will find a shrinking market for consumer paper which does not contain the anti-HDC clause. Thus, to the extent that creditors comply with the rule, the market would be policed by creditors reluctant to deal with shady dealers. However, there are difficulties even with this modified version of the rule.

Since the FTC has no jurisdiction over banks,[125] a significant segment of the consumer credit market will not be affected by the proposed change.[126] The original version of the Magnuson-Moss Amendment contained a provision which eliminated this jurisdictional exemption over banks and granted the FTC authority to make rules governing bank practices which affect consumers.[127] The provision was not retained in the final bill because of the FTC's lack of expertise in the field of banking.[128] This jurisdictional omission is cured by the requirement that

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[124] The proposed rule provides:

§ 433.2 Preservation of Consumers' Claims and Defenses, Unfair or Deceptive Acts or Practices.

In connection with any Purchase Money Loan (as that term is defined in § 433.1) or any sale or lease of goods or services, in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, it constitutes an unfair or deceptive act or practice within the meaning of Section 5 of that Act, for a *seller or a creditor*, directly or indirectly, to take or receive a consumer credit contract which fails to contain the following provision in at least ten point, bold face type:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL BE LIMITED TO AMOUNTS PAID BY THE DEBTOR HEREUNDER.

Proposed FTC Reg. § 433.2, 40 Fed. Reg. 53530 (1975)(emphasis added).

[125] 15 U.S.C.A. § 45(a)(2)(Supp. 1976), 89 Stat. 801, *formerly* 15 U.S.C. § 45 (a)(6)(Supp. IV, 1974).

[126] *See* The National Comm'n on Consumer Finance, Consumer Credit in the United States 11 (1972) (41.4 percent of all consumer credit in 1970 was held by banks).

[127] Senate Comm. on Banking, Housing and Urban Affairs, Amending Consumer Product Warranties Bill, S. Doc. No. 280, 93d Cong., 1st Sess. 2 (1973).

[128] *Id.* at 1-2.

those agencies which control banks[129] should, whenever the FTC prescribes a substantive consumer protection rule, within 60 days, pass a substantially similar regulation prohibiting the same type of acts by banks.[130] This requirement, however, does not apply to the current version of the anti-HDC rule. The Magnuson-Moss Amendment provides that proposed rules with respect to which presentation of data, views, and arguments were substantially completed prior to January 4, 1975, are not subject to the amendment.[131] Therefore, the anti-HDC rule need not be duplicated by the Federal Reserve Board nor the other agencies which control banks.

If the proposed expansion of the anti-HDC rule to include creditors is promulgated, it would be within the amendment's mandate that the agencies controlling banks consider a similar rule. The Federal Reserve Board has already proposed its own anti-HDC rule in anticipation that the expanded version of the rule will be promulgated by the FTC.[132] If the FTC passes the expanded rule, and if the Federal Reserve Board and other bank control agencies pass a similar rule, the consumer credit market will be substantially covered.

Conclusion

The anti-HDC rule in its present form suffers from a debilitating omission: creditors are excluded from its mandate. This omission creates difficulties which will hamper enforcement efforts. The proposed coverage of creditors is an improvement since it approaches the FTC's avowed goal of creditor supervision of seller conduct. The likely result of the new coverage, however, will be less favorable. It must be assumed that the negotiability of commercial paper will be further impaired,

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[129] Compliance with this requirement is enforced, in the case of:

(A) national banks and banks operating under the code of law for the District of Columbia, by the division of consumer affairs established by the Comptroller of the Currency;

(B) member banks of the Federal Reserve System (other than banks referred to in subparagraph (A)), by the division of consumer affairs established by the Board of Governors of the Federal Reserve System; and

(C) banks insured by the Federal Deposit Insurance Corporation (other than banks referred to in subparagraph (A) or (B)), by the division of consumer affairs established by the Board of Directors of the Federal Deposit Insurance Corporation.

15 U.S.C. § 57a (f)(2)(Supp. IV, 1974).

[130] *Id.* § 57a(f)(1)(Supp. IV, 1974). This action is discretionary. The Board may decide not to follow the FTC lead if it determines that to do so would "seriously conflict with essential monetary and payment systems policies of the Board . . . ." *Id.*

[131] Magnuson-Moss Amendment, *supra* note 82, at § 202(c).

[132] 41 Fed. Reg. 7110 (1976).

resulting in higher costs of credit—costs borne in the end by the consumer.

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RECENT DECISIONS

CONSTITUTIONAL LAW—STATE TAXATION—NONDISCRIMINATORY AD VALOREM PROPERTY TAX ON IMPORTED GOODS NO LONGER IN TRANSIT NOT VIOLATIVE OF IMPORT-EXPORT CLAUSE

The Michelin Tire Corporation[1] brought an action for declaratory and injunctive relief against the Tax Commissioner and Tax Assessors of Gwinnett County, Georgia, following the county's assessment of a nondiscriminatory[2] ad valorem[3] property tax on automobile tires and tubes imported by Michelin and warehoused within the county pending wholesale distribution.[4] Regardless of the situs of manufacture, the tires and tubes reach the Gwinnett County distribution warehouse in over-the-road trailers or sea vans.[5] These containers are packed and sealed at the foreign factory and remain sealed until unloaded at the warehouse at which time the tires and tubes are stacked and sorted on wooden pallets according to size and style.[6] On the basis of these facts, the Superior Court of Gwinnett County upheld Michelin's claim that the county assessment was a tax on foreign imports in violation of article I, section 10, clause 2 of the United States Constitution[7] and issued a permanent injunction

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[1] Michelin is a New York corporation authorized to do business in Georgia. Michelin Tire Corp. v. Wages, 96 S. Ct. 535, 538 (1976).

[2] Nondiscriminatory is used here to describe a tax which applies equally to domestic and imported goods. *See generally* Early & Weitzman, *A Century of Dissent: The Immunity of Goods Imported for Resale From State Personal Property Taxes*, 7 SW. U.L. REV. 247 (1975). Justice Cardozo defined a nondiscriminatory tax as follows:

> It lays a burden on all impartially. Finally, it is not oppressive in amount, nor framed in such a form as to suggest a furtive purpose to stifle activities not covered by its terms.

Anglo-Chilean Corp. v. Alabama, 288 U.S. 218, 238 (1933) (Cardozo, J., dissenting).

[3] The term ad valorem means literally according to value. An ad valorem duty is assessed "in the form of a percentage on the value of the property . . . ." BLACK'S LAW DICTIONARY 58 (rev. 4th ed. 1968).

[4] Michelin tires and tubes are imported into the United States from factories in France and Nova Scotia. Upon arrival in this country, Michelin pays a 4 percent federal import duty on all shipments. The tires and tubes in the Gwinnett County warehouse are not sold to retail customers, but are sold exclusively to Michelin's 250 to 300 franchised dealers in six southeastern states. Dealer orders are filled either through customer pickup or common carrier delivery. Wages v. Michelin Tire Corp., 233 Ga. 712, 214 S.E.2d 349, 349-50 (1975), *aff'd on other grounds*, 96 S. Ct. 535 (1976). This process entails further severance of the particular shipment in addition to the stacking and sorting occurring upon arrival at the warehouse. See note 6 and accompanying text *infra*.

[5] Sea vans are "basically over-the-road trailers with removable wheels" used to facilitate transoceanic shipping. Wages v. Michelin Tire Corp., 233 Ga. 712, 214 S.E.2d 349, 350 (1975), *aff'd on other grounds*, 96 S. Ct. 535 (1976).

[6] Although each tire has a unique serial number, the stacking and sorting is done without regard to the place of manufacture. The tires and tubes are in no way physically altered. 96 S. Ct. at 538.

[7] The import-export clause states:

forbidding its collection.[8] The tax commissioner appealed this ruling to the Supreme Court of Georgia contending that the warehouse inventory had become so identified and commingled with other property in the state that it had lost its status as an import and thus, under longstanding precedent, was amenable to state taxation.[9] The Supreme Court of Georgia accepted this argument and reversed the lower court decision.[10] On writ of certiorari to the United States Supreme Court, *held*, affirmed. A state nondiscriminatory ad valorem property tax against imported goods no longer in transit does not violate the constitutional prohibition against state taxation of imports or exports. *Michelin Tire Corp. v. Wages*, 96 S. Ct. 535 (1976).

Among the more fundamental defects of the Articles of Confederation was the inability of the national government to regulate trade either between the states or with foreign governments. Despite an unsuccessful attempt to remedy this flaw during the confederacy,[11] the problem continued until the constitutional mechanics assembled for the federal convention in 1787. The framers of the Constitution were confronted with a problem of finance and geography. First, the national government's inability to effectively tax imports, exclusive of the states' concurrent power to do likewise, had resulted in fiscal chaos and economic subservience to tightfisted state legislatures. The convention considered exclusive federal taxation of imports the most practical and least oppressive method of gaining a stable source of revenue for the central government.[12] Second, and perhaps more important in the present context, simple facts of geography had placed some states in a position to tax the foreign commerce of less favorably located inland states. Such exactions depressed inland markets and thus retarded national economic growth. In addition, these transit fees had

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> No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws: and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States; and all such Laws shall be subject to the Revision and Control of the Congress.

U.S. CONST. art. I, § 10, cl. 2.

[8] Wages v. Michelin Tire Corp., 233 Ga. 713, 214 S.E.2d 349, 350 (1975), *aff'd on other grounds*, 96 S. Ct. 535 (1976).

[9] 214 S.E.2d at 355.

[10] *Id.* The Supreme Court of Georgia, however, recognized two of Michelin's arguments against the tax. The court held that a nondiscriminatory ad valorem property tax on the warehouse inventory was in fact a tax on imports barred by the Constitution. In addition, the court held that the removal of the tires and tubes from the sea vans and over-the-road trailers did not constitute a fracture of the "original package." The decision rested solely on the county's argument that the tires and tubes had lost their identity as imports. Wages v. Michelin Tire Corp., 233 Ga. 712, 214 S.E. 2d 349, 355 (1975), *aff'd on other grounds*, 96 S. Ct. 535 (1976).

[11] 1 J. STORY, COMMENTARIES ON THE CONSTITUTION §§ 253-60 (5th ed. 1891).

[12] *See generally* THE FEDERALIST No. 12 (A. Hamilton). The convention was not, of course, unanimous in its support of such measures. *See Address by Luther Martin to the Maryland Legislature*, Nov. 29, 1787, in 3 M. FARRAND, THE RECORDS OF THE FEDERAL CONVENTION OF 1787 at 215-16 (rev. ed. 1937).

driven the wedge of colonial disunity even deeper and presented a real danger of splintering what little cohesion the Articles of Confederation had created among the states.[13] Consequently, the final draft of the new Constitution contained a provision correcting these two impediments to federalism—the import-export clause.[14] The first challenge to the framers' craftsmanship and the integrity of the import-export clause came in the landmark case of *Brown v. Maryland*.[15] *Brown* involved the constitutionality of a Maryland statute requiring importers of certain products to obtain a license from the state.[16] Substantial fines resulted from noncompliance.[17] Maryland[18] argued that the tax was neither directly nor indirectly a tax on imports, but rather a tax on those who engage in a particular trade or profession within the state.[19] Furthermore, the Constitution only prohibited state taxation of the "act of importation."[20] To hold otherwise, Maryland contended, would sanction an unwarranted usurpation of state sovereignty and effectively prevent the state from ever taxing the imported article.[21] Chief Justice Marshall, however, disagreed. Justice Marshall reasoned that the power to prohibit sale of an imported item is no different, in practical effect, from the power to prevent its importation.[22] Affirmance of the Maryland statute would permit a state to tax the sale of a foreign good to such an extent that its importation would become economic folly. Nevertheless, Justice Marshall recognized the friction between the constitutional mandate and the state's undisputed power to tax its citizens and their property. The Chief Justice metaphorically concluded that the dilemma presented so many basic competing interests that its consideration tended to "perplex the understanding."[23] Thus, a perplexed Marshall found it

> premature to state any rule as being universal in its application. It is sufficient for the present to say, generally, that when the importer has so acted upon the thing imported that it has become incorporated and mixed up with the mass of property in the country, it has, perhaps, lost

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[13] James Madison, *Preface to Debates in the Convention of 1787*, in 3 M. FARRAND, *supra* note 12, at 542.

[14] U.S. CONST. art. I, § 10, cl. 2. Madison contended that the addition of the "net produce" section rendered the prohibition on state taxation of imports absolute. James Madison, *Journal of the Federal Convention of 1787*, Aug. 28, 1787, in 2 M. FARRAND, *supra* note 12, at 441-42.

[15] 25 U.S. (12 Wheat.) 419 (1827).

[16] *Id.* at 419-20.

[17] *Id.* at 420.

[18] Counsel for Maryland included Roger B. Taney who was later appointed Chief Justice of the United States Supreme Court. In his opinion in *The License Cases*, Chief Justice Taney intimated that his views had changed since his argument before the Court in *Brown*. "[F]urther and more mature reflection has convinced me that the rule laid down by the Supreme Court is a just and safe one . . . ." The License Cases, 46 U.S. (5 How.) 504, 575 (1847).

[19] 25 U.S. (12 Wheat.) at 425-26.

[20] *Id.* at 426.

[21] *Id.* at 425-27.

[22] *Id.* at 439.

[23] *Id.* at 441.

> its distinctive character as an import, and has become subject to the taxing power of the State; but while remaining the property of the importer, in his warehouse, in the original form or package in which it was imported, a tax upon it is too plainly a duty on imports to escape the prohibition in the constitution.[24]

Twenty years after the historic *Brown* decision, the "original package" doctrine was affirmed by Chief Justice Taney in *The License Cases.*[25] Justice Taney developed further a concept which Justice Marshall had alluded to throughout *Brown:* While an import remains "*in transitu*," state taxation is prohibited.[26] The restriction was not, however, absolute in that the importer, like any citizen, is open to state assessment for all his property even though such property might include funds committed to commerce or imported goods which he intends to sell.[27] The reference to a property tax is unmistakable. Furthermore, this conclusion finds support in Professor William Crosskey's analysis of federal convention era language and word usage.[28] Crosskey concluded his examination of the import-export clause by observing that the common usage of the period did not include a general property tax among the levies which were generally considered "duties." Thus a property tax would not fall within the scope of the import-export clause restrictions since it was not considered a "duty" by the framers.[29] Crosskey's conclusion was "eminently sensible" since an annual property tax is intrinsically nondiscriminatory and does not produce the evils which the framers had intended to extinguish.[30] In 1868 the Court handed down three decisions[31] construing the import-export clause. The most important of these, *Woodruff v. Parham*,[32] marks the break, insofar as the import-export clause is concerned, between imports from other states and imports from foreign countries. In addition, this case initiated a gradual process of interpretation which has, for all practical purposes, emasculated the original package test. In *Woodruff*, Justice Miller explained that any reference by Chief Justice Marshall in *Brown* to

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[24] *Id.* at 441-42. From this rather timid proposal for a constitutional test emerged the "original package" doctrine which remained, at least until recently, the major standard of review in import taxation cases. *See generally* Dakin, *The Protective Cloak of the Export-Import Clause: Immunity for the Goods or Immunity for the Process?* 19 LA. L. REV. 747 (1959); 36 OHIO ST. L.J. 421 (1975).

[25] 46 U.S. (5 How.) 504 (1847).

[26] *Id.* at 575-76.

[27] *Id.* at 576.

[28] 1 W. CROSSKEY, POLITICS AND THE CONSTITUTION IN THE HISTORY OF THE UNITED STATES 295-323 (1953). Professor Crosskey used contemporary sources in his massive study into the "true" meaning of the Constitution. The source material from which the above conclusion evolved consisted mainly of newspapers.

[29] *Id.* at 296.

[30] *Id.*; *see* notes 12 through 14 and accompanying text *supra.*

[31] Hinson v. Lott, 75 U.S. (8 Wall.) 148 (1868); Woodruff v. Parham, 75 U.S. (8 Wall.) 123 (1868); Waring v. Mayor, 75 U.S. (8 Wall.) 110 (1868). *Waring* presented the interesting question of the importer's identity. This question has appeared numerous times in the original package cases. *See* 7 LOYOLA L.A.L. REV. 350, 352-54 (1974).

[32] 75 U.S. (8 Wall.) 123 (1868).

interstate imports was mere dictum.[33] As a result, a nondiscriminatory[34] sales tax on goods imported into Alabama from other states was left intact. Nevertheless, in *Low v. Austin*,[35] Justice Field used *Brown* and the original package doctrine to reverse the Supreme Court of California's decision that a nondiscriminatory ad valorem property tax assessed against wines in their original crates awaiting sale was not a duty on imports.[36] The Court refused to impute any special redeeming qualities to a tax nondiscriminatory in its application and effect.[37] By 1900 the Court was trapped in the original package Marshall had

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[33] *Id.* at 139; *accord*, Sonneborn Bros. v. Keeling, 265 U.S. 506, 511-12 (1923). Marshall's words were: "[W]e suppose the principles laid down in this case, to apply equally to importations from a sister state." Brown v. Maryland, 25 U.S. (12 Wheat.) 419, 449 (1827).

[34] Justice Miller, writing for the majority, stressed the importance of the fact that the tax did not "discriminate injuriously against the products of other States or the rights of their citizens . . . ." Woodruff v. Parham, 75 U.S. (8 Wall.) 123, 140 (1868). Such reasoning was later affirmed in Brown v. Houston, 114 U.S. 622 (1885), and again in New York *ex rel.* Burke v. Wells, 208 U.S. 14, 22 (1908), where the Court, quoting Brown v. Maryland, 25 U.S. (12 Wheat.) 419, 441 (1827), recognized that the import tax prohibition, at least in the context of interstate commerce, should be applied "no further than to prevent the States from doing that which it was the great object of the Constitution to prevent." *Accord*, American Steel & Wire Co. v. Speed, 192 U.S. 500 (1904).

[35] 80 U.S. (13 Wall.) 29 (1872).

[36] The California court did not believe such a tax fell within the general rule provided by Marshall in *Brown*. The court was unable to accept the importer's contention that the wine had not become part of the general mass of the property within the state since it was offered for sale in state markets. In addition, the court reasoned that the goods were under the protection of California laws and services and should be obligated to contribute for such privileges. *Id.* at 30-31. *See* Comment, *State Taxation of Imports—When Does an Import Cease to Be An Import?*, 58 HARV. L. REV. 858, 865 (1945).

[37] Justice Field concluded that "the question is not as to the extent of the tax, or its equality with respect to taxes on other property, but as to the power of the State to levy any tax." Low v. Austin, 80 U.S. (13 Wall.) 29, 34 (1872). In commenting on an export problem, Justice Douglas remarked that "it would entail a substantial revision of the Import-Export Clause to substitute for the prohibition against 'any' tax a prohibition against 'any discriminatory' tax." Richfield Oil Corp. v. State Bd. of Equalization, 329 U.S. 69, 76 (1946). *Low* continued to be the prime obstacle to state nondiscriminatory ad valorem property taxes against imports held for sale. *See* Sterling Liquor Distrib., Inc. v. County of Orange, 3 Cal. App. 3d 510, 83 Cal. Rptr. 571 (1970), *cert. denied*, 400 U.S. 822 (1970). The *Low* Court found no evidence that the imported wine "had passed from the control of the importer or been broken up by him from their original cases." Low v. Austin, 80 U.S. (13 Wall.) 29, 34 (1872). Consequently, original package doctrine protection remained. Again, the disparity between application of the original package doctrine to domestic imports and foreign imports is apparent. In 1933, the Court held that, in interstate commerce cases at least:

> Where property has *come to rest* within a State, being held there at the pleasure of the owner, for disposal or use, so that he may dispose of it either within the State, *or* for shipment elsewhere, as his interest dictates, it is deemed to be a part of the general mass of property within the State and is thus subject to its taxing power.

Minnesota v. Blasius, 290 U.S. 1, 10 (1933) (emphasis added). An interesting exception

proposed in 1827. The theory was proving to be much too rigid for sensible application to the business community. Consequently, fact situations such as the one presented in *May v. New Orleans*[38] forced constant reinterpretation of the original package doctrine.

In *May*, Justice Harlan was compelled to choose between the original packing crate and the original individual pasteboard box as the ultimate original package.[39] This choice was determinative of the case since the packing crate had been opened and thus changed to such a degree by the importer that it had forfeited its identity as an import and become subject to state taxation.[40] Identification of the point at which an article loses its identity as an import has been a constant source of judicial irritation since virtually all imported shipments of goods are surrounded by a unique original package and are subject to varying methods of processing for eventual sale.[41] Similar confusion and contradiction has resulted where the importer acquired the imported goods "for his own use."[42]

In *Hooven & Allison Co. v. Evatt*,[43] Ohio assessed a nondiscriminatory ad valorem property tax against bales of hemp, in their original packages, which

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to this formula was made by the Supreme Court of Washington when it refused to follow this line of cases and, instead, elected to maintain strict obedience to *Brown*. This, of course, provoked a strong dissent which accused the majority of making "a fetish of a formula." Washington Chocolate Co. v. King County, 21 Wash. 2d 630, 152 P.2d 981, 993, *cert. denied*, 324 U.S. 880 (1944). For a general criticism of the original package doctrine in the context of interstate commerce, see Trickett, *The Original Package Ineptitude*, 6 COLUM. L. REV. 161 (1906).

[38] 178 U.S. 496 (1900).

[39] May & Company imported linens into the United States from Europe. The linens were packaged in boxes of one dozen each, and these cartons were eventually bundled into a wooden packing crate for shipment. *Id.* at 498-99.

[40] *Id.* at 508-09.

[41] *See* Galveston v. Mexican Petroleum Corp., 15 F.2d 208 (S.D. Tex. 1926). *Contra*, Mexican Petroleum Corp. v. South Portland, 121 Me. 128, 115 A. 900 (1922). The courts have had an especially difficult time with goods which cannot be "packaged" in the ordinary sense. *See, e.g.*, Gulf Fisheries Co. v. MacInerney, 276 U.S. 124 (1928) (fish); Dant & Russell, Inc. v. Board of Supervisors, 128 P.2d 389 (2d Dist. Ct. App. 1942), *rev'd on other grounds*, 21 Cal. 2d 534, 133 P.2d 817 (Sup. Ct.), *cert. denied*, 320 U.S. 735 (1943) (individual board in lumber shipment is original package). *Compare* Simon v. Los Angeles, 141 Cal. 2d 74, 296 P.2d 381 (2d Dist. Ct. App. 1956), *and* Florida Greenhart Corp. v. Gautier, 172 So. 2d 589 (Fla.), *cert. denied*, 382 U.S. 825 (1965), *with* Stanton & Sons v. Los Angeles County, 78 Cal. App. 2d 181, 177 P.2d 804 (2d Dist. Ct. App.), *cert. denied*, 332 U.S. 766 (1947). Hypothecation of the import has presented an especially complex problem for the courts. Southern Pac. Co. v. Calexico, 288 F. 634 (S.D. Cal. 1923); *accord*, Halo Sales Corp. v. San Francisco, 6 Cal. App. 3d 205, 490 P.2d 1161, 98 Cal. Rptr. 473 (1971). *See generally* for other impossible-to-package items, Tres Tritos Ranch Co. v. Abbott, 44 N.M. 556, 105 P.2d 1070 (1940) (cattle); Citroen Cars Corp. v. City of New York, 30 N.Y.2d 300, 283 N.E.2d 758, 332 N.Y.S. 882 (1972) (automobiles).

[42] The "for his own use" language was, like all import-export clause terminology, drawn from *Brown* where Justice Marshall employed the phrase when addressing issues different from those in which it would later be used. Brown v. Maryland, 25 U.S. (12 Wheat.) 419, 443 (1827).

[43] 324 U.S. 652 (1945). *See* Comment, *supra* note 36.

the petitioner had stored in its warehouse pending use in its cordage manufacturing operation.[44] The Supreme Court of Ohio, using the "come to rest" reasoning familiar to interstate commerce cases, upheld the tax.[45] As imposed, the tax did not intercept the import before sale, a condition which Marshall had diagnosed as the fatal defect of state import taxes.[46] Chief Justice Stone, writing for the Supreme Court of the United States, however, disagreed and refused to extend interstate commerce principles to an intransient foreign inventory.[47] Of equal importance was the Court's evasion of a concept, intimated by the Ohio court, that since the hemp had been stored in anticipation of "current operational needs,"[48] the incorporation requirement had been met and the inventory became inseparable from the common mass of property. Unfortunately, the Chief Justice considered the subject irrelevant since the lower court decision was not founded on such a hypothesis.[49] In support of the Ohio court, a strong dissent by Justice Black pointed to inconsistencies which would be spawned by the majority's analysis[50] and emphasized the nondiscriminatory nature of the tax.[51] Fifteen years later, these arguments were persuasive to the majority in *Youngstown Sheet & Tube Co. v. Bowers*.[52] The *Youngstown* Court was impressed by the stipulated fact that the imported material was specifically imported "for ultimate use" in the importer's manufacturing facility.[53] On this

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[44] 324 U.S. at 654.

[45] Hooven & Allison Co. v. Evatt, 142 Ohio St. 235, 240-43, 51 N.E.2d 723, 726 (1943), *rev'd*, 324 U.S. 652 (1944). *See* note 36 and accompanying text *supra*.

[46] Brown v. Maryland, 25 U.S. (12 Wheat.) 419, 443 (1827).

[47] 324 U.S. at 664.

[48] *Id.* at 667.

[49] The Court was technically correct in this conclusion. The Ohio court, however, clearly implied this analysis. Hooven & Allison Co. v. Evatt, 142 Ohio St. 235, 243-44, 51 N.E.2d 723, 727 (1943), *rev'd*, 324 U.S. 652 (1945).

[50] Justice Black warned that the majority had created

> this rather odd situation: One who imports goods himself and holds them for his own use in his factory is not liable [for] state taxes on such goods; but if he bought the goods from one engaged in the business of importing, he *would* be liable to taxation on the same goods.

324 U.S. at 689. (Black, J., dissenting).

[51] The most fertile imagination would be hard put to prove that it would injure or threaten any other state for Ohio to collect its nondiscriminatory *ad valorem* tax on fibers held for use in that state.

Id. at 690 (Black, J., dissenting).

[52] 358 U.S. 534 (1958). Decided with *Youngstown* was United States Plywood Corp. v. City of Algoma, 358 U.S. 534 (1958), in which the facts differed little from those in *Youngstown*. *See* Dakin, *supra* note 24; *The Supreme Court, 1958 Term*, 73 HARV. L. REV. 176 (1959); 1959 WIS. L. REV. 330.

[53] 358 U.S. at 536. Why the majority in *Hooven* was unimpressed with this fact is unclear since the hemp was also held for use in the manufacturer's production line. In fact, Chief Justice Stone stated that once imported articles are "put to the use for which they are imported" identity as an import is surrendered. Hooven & Allison Co. v. Evatt, 324 U.S. 652, 657 (1945). The Court in *Youngstown* stressed that its facts were stipulated and pointed to questions the *Hooven* Court felt unable to reach. 358 U.S. at 544-46. Thus, the stipulation of facts is the only "legal" distinction between the two cases.

fact, the Court held that when a manufacturer imports material "essential" to meeting its current operational needs, it has acted upon the goods in a manner inconsistent with the constitutional definition of "import" and rendered them vulnerable to state assessment.[54] Ambiguities remained, however, insofar as the courts lacked a practical test for determining the current operational needs of a particular business. Eventually, the Supreme Court of Colorado approved a lower court scheme which used the time necessary for the manufacturer to restock its inventory of imported material as the unit for assessment.[55] Recent decisions have unsuccessfully attempted to extend the *Youngstown* standard to goods held in an importer's wholesale warehouse awaiting distribution to its retail outlets.[56]

In the instant case, the Court refused to consider the issue of whether the Georgia court was correct in holding that the tires and tubes had lost their identity as imports.[57] Instead, the Court reasoned that since an ad valorem property tax does not intercept the imported item before incorporation into the general mass of property[58] and does not discriminate against imported products because of their foreign origin,[59] such a tax cannot be considered a duty in the sense the framers had intended.[60] Furthermore, a general property tax cannot

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[54] 358 U.S. at 549.

[55] City & County of Denver v. Denver Publishing Co., 153 Colo. 539, 387 P.2d 48, 53 (1963). Thus, if it took the manufacturer 6 days to replenish the stock of material essential to its manufacturing process, a 6-day supply of the material was taxable. Reaction to the Colorado test has been mixed. Ohio, in Orr Felt & Blanket Co. v. Schneider, 3 Ohio St. 2d 14, 209 N.E.2d 150 (1965), immediately accepted the test, as did Oregon in Beall Pipe & Tank Corp. v. State Tax Comm'n, 254 Ore. 195, 458 P.2d 420 (1969), and Michigan in Knight Newspapers, Inc. v. City of Detroit, 16 Mich. App. 438, 168 N.W.2d 318 (1969). The Michigan decision has since been overruled. Production Steel Strip Corp. v. City of Detroit, 390 Mich. 508, 213 N.W.2d 419 (1973). California courts have never adopted the test, claiming that such a restriction is unwarranted under *Youngstown* and that the entire inventory is open to assessment once irrevocably committed to production. Virtue Bros. v. County of Los Angeles, 239 Cal. App. 2d 220, 48 Cal. Rptr. 505 (2d Dist. Ct. App.), *cert. denied*, 385 U.S. 820 (1966).

[56] *See* Montgomery Ward & Co. v. County of Alameda, 390 F. Supp. 177 (N.D. Cal. 1975); Sears, Roebuck & Co. v. County of Kings, 53 Cal. 3d 381, 126 Cal. Rptr. 128 (5th Dist. Ct. App. 1976) (Michelin tires held in Sears warehouse pending distribution to Sears retail outlets); City of Farmers Branch v. American Honda Co., 527 S.W.2d 776 (Tex. 1975).

[57] Michelin Tire Corp. v. Wages, 96 S. Ct. 535, 538 (1976). The Supreme Court of Georgia had taken what most observers believed to be the next logical step after the *Youngstown* decision. This extension of original package analysis was certainly reasonable in light of the Court's previous contortions of Marshall's language in *Brown*. *See* Dakin, *supra* note 24; 1959 WIS. L. REV. 330; notes 10 & 43 and accompanying text *supra*.

[58] 96 S. Ct. at 546. *See* note 45 and accompanying text *supra*.

[59] *Id.* at 546.

[60] The Court stressed the importance of Professor Crosskey's research and his conclusion that a nondiscriminatory ad valorem property tax is not a "duty" in the sense the framers had intended. *Id.* at 543-44. *See* notes 28 through 30 and accompanying text *supra*. Nevertheless, it seems odd that Marshall, in 1827, did not recognize this fact. The obvious answer, which *Michelin* adopts, is that *Brown* did not consider a property tax and

be considered a transit fee since it may be imposed only on goods which have ceased to be in transit[61] and have enjoyed the protective services provided by local governments.[62] Thus, instead of overflowing the state coffers, a general property tax merely permits local governments to recoup part of the expense incurred in protecting the imported inventory. Consequently, such a tax does not conflict with the purposes and general policies of the import-export clause. As to the contrary result reached in *Low*,[63] Justice Brennan, writing for the unanimous Court, held that since the earlier decision was formed on an erroneous interpretation of *Brown*, inconsistent with the instant decision, *Low* was overruled.[64] The Court then concluded that a state nondiscriminatory ad valorem property tax levied on imported goods no longer in transit does not violate the import-export clause prohibition against state taxation of imports or exports.

Justice White, concurring, summarily stated that affirmance should be based on the Georgia court's conclusion that the tires had lost their identity as imports in a manner consistent with earlier cases. In addition, White viewed the overruling of *Low* as premature.[65]

The *Michelin* decision has at last put to rest a legal fiction which had long outlived its utility.[66] Original package analysis, once useful as an illustration,[67] had become the exception to the rule rather than the firm standard needed for consistent judicial interpretation. In rejecting this relic, the Court has removed much of the uncertainty and confusion surrounding the import-export clause. For this reason, *Michelin* must be viewed not as a surprise departure from venerable precedent, but as timely relief from old cases. Consequently, it is the methodology, rather than the result, on which future judicial attention will be focused.[68] After *Youngstown*, affirmance of a state nondiscriminatory ad valorem property tax on imported inventory no longer in transit seemed the next logical penetration of the import-export clause shield since few distinctions can be made between goods held for use in manufacturing and goods held for use in retail distribution. The instant decision, however, does not follow the *Youngstown* stratagem, for such an analysis necessarily includes original pack-

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therefore cannot be considered direct authority for rejection of such assessments. The fact that *Michelin* recognized this distinction is significant in that previous cases had paid undue reverence to *Brown* and its original package doctrine. *See, e.g.*, Low v. Austin, 80 U.S. (13 Wall.) 29 (1872). Rejecting *Low* and its progeny, *Michelin* recognizes the better, more flexible view "that the original package statement of Justice Marshall was an illustration, rather than a formula, and that its application is evidentiary, and not substantive . . . ." City of Galveston v. Mexican Petroleum Corp., 15 F.2d 208 (S.D. Tex. 1926).

[61] 96 S. Ct. at 548.

[62] *Id.* at 542.

[63] *See* notes 35 through 37 and accompanying text *supra*.

[64] 96 S. Ct. at 548.

[65] *Id.* at 548 (White, J., concurring).

[66] Indeed, the Court seems to make light of the judicial test which had dominated import-export clause cases for nearly 150 years. *See id.* at 546.

[67] *See* note 60 *supra*.

[68] *See* Peters, *Supreme Court Sets New Test for Local Taxation of Imports in Michelin Tire*, 4 J. Tax. 244 (1976).

age tools. Indeed, the *Michelin* Court makes clear that its affirmance approved only the tax and not the Georgia court's original package logic.[69] Yet the Court strikes beyond a refusal to accommodate the lower court's argument and into a reversal of *Low*.[70] Justice White considered this premature. However, the "further and more mature reflection"[71] which eventually convinced Chief Justice Taney of the wisdom of the *Brown* decision may prove the Court's clean break with the past to have been the only practical alternative. Further contortion of the already twisted original package would serve only to bury the genuine intent of the framers.[72] Instead, the Court seems to classify foreign imports with imports from other states traveling in interstate commerce. As a result, state taxation of foreign imports will now be regulated by commerce clause rules, themselves somewhat inconsistent,[73] instead of by the traditional import-export clause calculus. In a more practical context, however, the instant decision may spark less of a departure from existing practices than a purely legal analysis of the case might indicate. At first glance, the Court seems to have blessed financially troubled local governments, such as that of New York City, with an important new source of revenue. Unfortunately, further inquiry diminishes this blessing to an offer of doubtful value. New York City officials, for example, expressed immediate disapproval of such a tax because additional taxes on its importing business community would precipitate a mass exodus to more favorable tax environments in New Jersey.[74] For this reason, *Michelin* will induce even greater competition between seaport cities for the rich foreign trade which has shown dramatic increases in recent years.[75] Thus, in the final analysis, the *Michelin* grant may exert greater influence when ignored by local taxing authorities than if acted upon.

Jeffrey A. Walker

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[69] Despite this fact, the resulting impact of the instant decision may prove to be more of a ripple than a wave, since there are indications that some local taxing authorities had implemented *Michelin* some time before it was ever decided. When the Finance Director for the City of Atlanta, Georgia, was questioned as to his opinions concerning the Court's holding, he replied, "We levy on everything already except for merchandise which is already in transit . . . ." Atlanta Constitution, Jan. 15, 1976, § D, at 10, col. 4.

[70] 96 S. Ct. 535, 548.

[71] The License Cases, 46 U.S. (5 How.) 504, 575 (1847).

[72] Madison instructed that

> in expounding the Constitution and deducing the intention of its framers, it should never be forgotten, that the great object of the Convention was to provide, by a new Constitution, a remedy for the defects of the existing one . . . .

Madison, *Letter from James Madison to Professor Davis*, in 3 M. FARRAND, *supra* note 12, at 520. *See* notes 12 & 13 and accompanying text *supra*.

[73] *See* 36 LA. L. REV. 304 (1975).

[74] The New York Times, Jan. 15, 1976, § 1, at 1, col. 1.

[75] Recent statistics show that United States general imports have nearly doubled since 1972. The value of such imports in 1974 was well over $100 million. DEPARTMENT OF THE TREASURY, EAST-WEST FOREIGN TRADE BOARD REPORT, FIRST QUARTER 1975 at 47.

FEDERAL JURISDICTION—CIVIL RIGHTS JURISDICTION UNDER 28 U.S.C. § 1343(3) NOT AVAILABLE WHEN EQUITABLE MONETARY RELIEF, SOUGHT UNDER 42 U.S.C. § 1983, WOULD STEM DIRECTLY FROM MUNICIPAL FUNDS

Plaintiffs[1] brought a section 1983 class action[2] against the City of San Antonio, its Firemen's and Policemen's Pension Fund Board, and the individual members of the board, seeking declaratory and injunctive relief against enforcement of a Texas statute[3] which prohibited refund of pension fund payments made by former city employees. Challenging the constitutionality of the statutory provision,[4] plaintiffs specifically sought the refund of payments deducted while they were employed by the city.[5] Jurisdiction rested on sections 1983[6] and 1343(3).[7] The United States District Court for the Western District of Texas

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[1] Plaintiffs were former employees of the San Antonio Fire and Police Departments who filed the action on behalf of all former firemen and policemen of San Antonio.

[2] The suit began as one class action encompassing former firemen and policemen of the cities of San Antonio, Houston, Dallas, and El Paso, but the district court divided the suit into four separate actions, Walker v. City of Houston, 341 F. Supp. 1124 (S.D. Tex. 1971), each to be heard by a single-judge court, Walker v. City of Houston, 341 F. Supp. 1117 (S.D. Tex. 1971).

[3] TEX. REV. CIV. STAT. ANN. art. 6243f (Vernon's 1970). The statute provides that the city of San Antonio will maintain a pension fund to which all policemen and firemen must make obligatory payments in return for disability, death, and retirement benefits from the fund.

[4] *Id.* art. 6243f § 19 (Vernon's 1970) provides:

> [N]o member of either of said Departments or of said Fund shall ever be entitled to any refund from said Fund on account of the money deducted from that amount of their pay . . . which money is in itself declared to be public money, and the property of said Fund for the benefit of the members qualifying for benefits, and their beneficiaries.

[5] Plaintiffs originally sought damages against the defendants, including the board members in their individual capacities, but withdrew that claim in oral argument before the en banc court. Muzquiz v. City of San Antonio, 528 F.2d 499, 500 n.4 (5th Cir. 1976).

[6] The statute provides:

> Every person who, under color of any statute, ordinance, regulation, custom or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

42 U.S.C. § 1983 (1970).

[7] 28 U.S.C. § 1343 (1970) provides:

> The district courts shall have original jurisdiction of any civil action authorized by law to be commenced by any person:
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> . . . .
>
> (3) To redress the deprivation, under color of any State law, statute, ordinance, regulation, custom or usage, of any right, privilege or immunity secured by the Constitution of the United States or by any Act of Congress providing for equal rights of citizens or of all persons within the jurisdiction of the United States.

dismissed the city as a party[8] and, as to the remaining defendants, held the statute constitutional.[9] On appeal to the United States Court of Appeals for the Fifth Circuit, defendants argued that they were not "persons" within the meaning of section 1983 and that the court, therefore, lacked jurisdiction. Reaching the merits, a Fifth Circuit panel affirmed the district court's judgment.[10] On rehearing en banc, *held*, affirmed on other grounds. Where a municipal board, though not possessing broad governmental powers, is so closely related to the municipality that it constitutes an "arm" of the city, the board is not a "person" within the ambit of section 1983. If the practical effect of the requested relief would be to use the individual board members as conduits to public funds administered by the board, the suit is, in essence, against the board; hence "jurisdiction" is lacking under sections 1983 and 1343(3). *Muzquiz v. City of San Antonio*, 528 F.2d 499 (5th Cir. 1976).

A plaintiff who invokes section 1983 must satisfy several statutory conditions.[11] He must prove that the defendant acted "under color of" state law[12] to deprive him of a right "secured by the Constitution and laws of the United States."[13] In addition, the defendant must be a "person" within the meaning of section 1983.[14] In *Monroe v. Pape*,[15] the first in a series of Supreme Court cases defining the term "person," the Court relied heavily on section 1983's legislative

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Defendants also asserted jurisdiction under 28 U.S.C. § 1331 (1970), which provides in part:

> (a) The district courts shall have original jurisdiction of all civil actions wherein the matter in controversy exceeds the sum or value of $10,000, exclusive of interest and costs, and arises under the Constitution, laws, or treaties of the United States.

It was established by the parties' stipulations, however, that no class member's claim amounted to the $10,000 amount required by section 1331. Muzquiz v. City of San Antonio, 520 F.2d 993, 996 n.2 (1975), *aff'd en banc on other grounds*, 528 F.2d 499 (5th Cir. 1976).

[8] The district court held that the city was not a "person" within the meaning of section 1983. 378 F. Supp. 949, 951-52 (W.D. Tex. 1974), *citing* City of Kenosha v. Bruno, 412 U.S. 507 (1973). See notes 22 through 24 and accompanying text *infra*.

[9] 378 F. Supp. 949, 961 (W.D. Tex. 1974).

[10] Muzquiz v. City of San Antonio, 520 F.2d 993 (5th Cir. 1975). Judge Godbold submitted a forceful dissent protesting jurisdiction over the pension board for any form of relief and over the individual members in their official capacities for "any relief other than declaratory and injunctive." *Id.* at 1002 (Godbold, J., dissenting in part).

[11] Adickes v. Kress & Co., 398 U.S. 144, 150 (1970).

[12] 42 U.S.C. § 1983 (1970). There must be a "[m]isuse of power, possessed by virtue of state law and made possible only because the wrongdoer is clothed with the authority of state law . . . ." United States v. Classic, 313 U.S. 299, 326 (1941).

[13] 42 U.S.C. § 1983 (1970).

[14] *Id.*; *e.g.*, Fine v. City of New York, 529 F.2d 70, 73 (2d Cir. 1975).

[15] 365 U.S. 167 (1961). Plaintiffs in *Monroe* brought an action for damages against the City of Chicago and individual police officers alleging invasion of their constitutional rights in a particularly outrageous warrantless search and a subsequent unauthorized detention of Mr. Monroe. Though the plaintiffs were permitted to maintain an action against the individual officers involved, the complaint against the city was dismissed. *Id.* at 192.

history[16] to reach the conclusion that municipalities are not "persons" within the ambit of that statute.[17] Noting that Congress specifically refused to enact a proposal making municipalities liable for individual deprivations of federal rights, the Court concluded: "[W]e cannot believe that the word 'person' was used in this particular act to include [municipalities]."[18] The notion that "person" has a limited meaning was subsequently buttressed by the Court's decision in *Moor v. County of Alameda*[19] that counties, like municipalities, are "nonpersons" within the meaning of section 1983. Since both *Monroe* and *Moor* concerned only actions for damages, most lower courts interpreted these decisions as not precluding equitable actions against governmental entities.[20] Thus, for

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[16] The statute was originally enacted as the Civil Rights Act, Act of April 20, 1871, ch. 22, § 1, 17 Stat. 13. It was intended to provide a federal cause of action for those persons who were unable to obtain redress in state courts for infringements upon their constitutional rights. *See* Note, *The Civil Rights Act of 1871: Continuing Validity*, 40 NOTRE DAME LAW. 70 (1964).

[17] Mr. Justice Douglas, writing for the Court, seized upon the vehement rejection by the House of Representatives of the proposed Sherman Amendment to the Civil Rights Act in support of this conclusion. 365 U.S. at 188-89. The amendment would have made "the inhabitants of the county, city, or parish" in which "any house, tenement, cabin, shop, building, barn, or granary" was "destroyed, wholly or in part" or in which "any person [was] whipped, scourged, wounded, or killed by any persons riotously and tumultuously assembled together . . . liable to pay full compensation to the person or persons damnified by such offense . . . ." CONG. GLOBE, 42d Cong., 1st Sess. 663 (1871). The amendment further provided that judgment recovered in such a suit might be levied on "any property" in the geographical area involved and that the governmental entity might, after satisfying the judgment, recover the full amount from the individual wrongdoers. *Id.*

[18] 365 U.S. at 191. It is of interest that Mr. Justice Douglas summarily dismissed as merely optional the definition of "person" provided by the "Dictionary Act," Act of Feb. 25, 1871, ch. 71, § 2, 16 Stat. 431, which stated that "the word 'person' may extend and be applied to bodies politic and corporate . . . ." *Id.* This brief dismissal has been criticized as a glossing-over of the actual intent of Congress. Because the two acts were before Congress for consideration at the same time it is unlikely that the members intended that the same meaning should not apply to the word "person" as used in section 1 of the Civil Rights Act; surely a clearer term would have been substituted. *See* Note, *Developing Governmental Liability Under 42 U.S.C. § 1983*, 55 MINN. L. REV. 1201, 1206 (1971).

For further discussion and criticism of *Monroe's* interpretation of section 1983's legislative history see, *e.g.*, Kates & Kouba, *Liability of Public Entities Under Section 1983 of the Civil Rights Act*, 45 S. CAL. L. REV. 131, 132-36 (1972); Comment, *Toward State and Municipal Liability in Damages for Racial Equal Protection*, 57 CALIF. L. REV. 1142, 1165-67 (1969); Comment, *Suing Public Entities Under the Federal Civil Rights Act:* Monroe v. Pape *Reconsidered*, 43 U. COLO. L. REV. 105, 118-20 (1971).

[19] 411 U.S. 693 (1973).

[20] The *Monroe* opinion, in a footnote, recognized two cases in which plaintiffs sought equitable relief against municipalities but discounted them since the question of jurisdiction over municipalities under section 1983 was not before the court in those cases. The Court then stated, "Since we hold that a municipal corporation is not a 'person' within the meaning of Section 1983, no inference to the contrary can any longer be drawn from those cases." 365 U.S. at 191 n.50. This footnote resulted in confusion in the lower courts. One interpretation held that the footnote precluded any section 1983 suit against a municipal entity regardless of the relief sought. Deane Hill Country Club, Inc. v. City of Knox-

example, by treating back pay awards as an equitable remedy, these lower courts permitted use of sections 1983 and 1343(3) to vindicate teacher's fourteenth amendment claims against school boards and officials, regardless of the amount in controversy.[21] In *City of Kenosha v. Bruno*,[22] the Court disapproved this bifurcated approach, holding that a municipality was not a "person" within the meaning of the statute in both damage and equitable actions.[23] The Court, however, was careful not to exclude the possibility that a city could be a properly named defendant under the general federal question jurisdiction statute,[24] if the requisite $10,000 were in controversy. Although *Kenosha* established that the nature of the relief sought did not alter a municipality's amenability to suit, it failed to define what constitutes a municipality under section 1983. As a result, different methods of approaching the problem emerged.[25] Often these methods

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ville, 379 F.2d 321 (6th Cir.), *cert. denied*, 389 U.S. 975 (1967); *accord*, United States *ex rel.* Gittlemacker v. County of Philadephia, 413 F.2d 84 (3d Cir. 1969), *cert. denied*, 396 U.S. 1046 (1970); Diamond v. Pitchess, 411 F.2d 565 (9th Cir. 1969).

Some courts skirted the issue by finding that, in a suit for equitable relief, the particular defendant involved was not a municipal entity or corporation and was therefore amenable to suit under section 1983. *See, e.g.*, Aurora Educ. Ass'n v. Board of Educ., 490 F.2d 431 (7th Cir. 1973), *cert. denied*, 416 U.S. 985 (1974) (school board); Garren v. City of Winston-Salem, 439 F.2d 140 (4th Cir. 1971), *vacated on other grounds*, 405 U.S. 1052 (1972) (city).

The more prevalent view, however, was that taken by the Fifth Circuit in Harkless v. Sweeney Independent School Dist., 427 F.2d 319 (5th Cir. 1970), *cert. denied*, 400 U.S. 991 (1971). The *Harkless* court found that the Supreme Court did not intend to prohibit equitable relief in the form of declaratory or injunctive orders against municipalities or municipal entities even though such relief might involve monetary burdens on the public treasury as an integral part of the equitable relief. *Accord*, Griffin v. County School Bd., 377 U.S. 218 (1964); Smith v. Board of Educ., 365 F.2d 770 (8th Cir. 1966).

Another view held that injunctive relief was permissible in the form of prohibitory, though not mandatory, injunctive relief, presumably under the rationale that *Monroe* prohibited only relief which might draw on public funds. *See* Gonzales v. Doe, 476 F.2d 680, 685 n.9 (2d Cir. 1973); *cf.* Schnell v. City of Chicago, 407 F.2d 1084 (7th Cir. 1969); Adams v. City of Park Ridge, 293 F.2d 585 (7th Cir. 1961).

For a general discussion of the various lower court interpretations *Monroe's* footnote 50 see Comment, *Suing Public Entities Under the Federal Civil Rights Act*: Monroe v. Pape *Reconsidered*, *supra* note 18, at 108-17.

[21] *See, e.g.*, Harkless v. Sweeny Independent School Dist., 427 F.2d 319 (5th Cir. 1970), *cert. denied*, 400 U.S. 991 (1971).

[22] 412 U.S. 507 (1973).

[23] We find nothing in the legislative history discussed in *Monroe*, or in the language actually used by Congress, to suggest that the generic word "person" in § 1983 was intended to have a bifurcated application to municipal corporations depending on the nature of the relief sought against them. Since, as the Court held in *Monroe*, "Congress did not undertake to bring municipal corporations within the ambit of" § 1983 . . . they are outside of its ambit for purposes of equitable relief as well as for damages.

Id. at 513.

[24] 28 U.S.C. § 1331 (1970). See notes 66 through 68 and accompanying text *infra*.

[25] The circuits have generally found that municipal, county, and state agencies established by statute or ordinance, or maintained by the state or local government, financially

could be associated with a particular circuit, but different courts within the same circuit frequently adopted different approaches, which contributed significantly to the confusion.[26] Thus, whether an entity should be considered a "person" is somewhat problematical. This perforce follows because of the variety of governmental agencies each with its own particular functions and ties to the political subdivision involved. *Monroe-Kenosha* immunity has, consequently, been extended to a wide range of municipal entities.[27] Several courts have devised methods of distinguishing between entities which are "persons" under section 1983 and those which are not;[28] however, the ultimate inquiry seemingly

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or otherwise, are not "persons" within the ambit of section 1983. *See, e.g.*, Burt v. Board of Trustees, 521 F.2d 1201 (4th Cir. 1975) (county school board); Adkins v. Duval County School Bd., 511 F.2d 690 (5th Cir. 1975) (county school board); Garrett v. City of Hamtramck, 503 F.2d 1236 (6th Cir. 1974)(city planning commission); Jorden v. Metropolitian Util. Dist., 498 F.2d 514 (8th Cir. 1974)(utilities services district); Sykes v. California, 497 F.2d 197 (9th Cir. 1974)(state department of motor vehicles); Curtis v. Everette, 489 F.2d 516 (3d Cir. 1973), *cert. denied*, 416 U.S. 995 (1974)(state bureau of corrections); Harthaway v. Worcester City Hosp., 475 F.2d 701 (1st Cir. 1973)(city hospital); Coopersmith v. Supreme Court, 465 F.2d 993 (10th Cir. 1972) (Colorado court system and bar association); United States *ex rel.* Lee v. Illinois, 343 F.2d 120 (7th Cir. 1965)(city police department).

The judicial willingness to exclude subdivisions of a governmental entity from section 1983 coverage may be due in part to the second conspicuous vacuity left by *Kenosha:* A section 1983 plaintiff might still sue individual members of a particular board or other municipal entity as defendants—in their official capacities—for equitable relief. Thus, the plaintiff might reach the municipality which was otherwise removed from the scope of section 1983. Additionally, it is undisputed that one may sue an individial official in his personal capacity under section 1983. In such case "the liability is entirely personal in nature, intended to be satisfied out of the individual defendant's pocket." Collins v. Schoonfield, 363 F. Supp. 1152, 1156 (D. Md. 1973). Of course, it must be shown that the individual acted in bad faith. *See* notes 46 through 48 and accompanying text *infra.*

[26] For a more extensive delineation of the lower court positions, see Muzquiz v. City of San Antonio, 520 F.2d 993, 1004-05 & nn.4 through 8 (1975)(Godbold, J., dissenting in part), *aff'd en banc on other grounds*, 528 F.2d 499 (5th Cir. 1976).

[27] *See, e.g.*, Singleton v. Vance County Bd. of Educ., 501 F.2d 429 (4th Cir. 1974)(board of education not a "person"); Cheramie v. Tucker, 493 F.2d 586 (5th Cir.), *cert. denied*, 419 U.S. 868 (1974) (arms of state government such as department of highways not a "person"); Blanton v. State Univ., 489 F.2d 377 (2d Cir. 1973)(state university not a "person"); Lehman v. City of Pittsburgh, 474 F.2d 21 (3d Cir. 1973)(city civil service commission not a "person"); Henschel v. Worchester Police Dept., 445 F.2d 624 (1st Cir. 1971) (city police department not a "person"); Davis v. United States, 439 F.2d 1118 (8th Cir. 1971)(per curiam)(city department of public welfare not a "person"); Sellers v. Regents of Univ. of Cal., 432 F.2d 493 (9th Cir. 1970), *cert. denied*, 401 U.S. 981 (1971)(regents of state university, a corporate body, not a "person"); United States *ex rel.* Gittlemacker v. County of Philadelphia, 413 F.2d 84 (3d Cir. 1969), *cert. denied*, 396 U.S. 1046 (1970)(city hospital not a "person"); Clark v. Washington, 366 F.2d 678 (9th Cir. 1966) (state bar association not a "person"); Sams v. New York State Bd. of Parole, 352 F. Supp. 296 (S.D.N.Y. 1972)(parole board not a "person").

[28] *E.g.*, Jorden v. Metropolitan Util. Dist., 498 F.2d 514 (8th Cir. 1974). In *Jorden*, the court refused to draw the often nebulous distinction between the proprietary and governmental functions of a municipal corporation in order to settle the question of its section 1983 liabilities. The court decided that it is not the business in which the entity

becomes "whether the public body is so connected—administratively, functionally, fiscally, and in other ways—to a state, city, or county that . . . it is in effect an arm . . . of the state, city, or county."[29] Thus, the different powers, duties, and resources of each public agency seem to be the touchstone for determining amenability to suit under section 1983.

Many lower courts, in search of guidance on the "person" problem, looked to other areas of the law for instruction and logically gravitated toward the theories advanced in resolving closely related eleventh amendment[30] questions. The eleventh amendment, however, extends only to states and not to its political subdivisions.[31] Thus, municipalities are not actually "immune" to suit under section 1983—they simply are not within the scope of the statute.[32] Yet, courts found the immunity rationale a useful analytical tool in section 1983 cases. *Ex Parte Young*,[33] a landmark eleventh amendment case, held that the eleventh amendment immunity could not be extended to protect a state official in a suit to enjoin him from enforcing an unconstitutional statute. Under this doctrine, an official acting unconstitutionally is stripped of his official cloak and may be ordered to perform his duties in a manner consonant with the Constitution. The state is presumed not to accede to unlawful actions taken by its officials; therefore, an order directing the official to correct his action is not directed against the state.[34] Similarly, lower courts have held that although an entity may not be a "person" within the purview of section 1983, officials of that entity are "persons" and subject to suit.[35] A number of the courts allowing such suits limit

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engages that excludes it from the language of section 1983, but the fact that it is what it is—a municipal corporation. *Id.* at 516.

[29] Muzquiz v. City of San Antonio, 520 F.2d 993, 1005 (1975)(Godbold, J., dissenting in part), *aff'd en banc on other grounds*, 528 F.2d 499 (5th Cir. 1976).

[30] The judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.

U.S. CONST. amend. XI.

[31] Edelman v. Jordan, 415 U.S. 651, 667 n.12 (1974).

[T]he eleventh amendment apparently stands as an absolute bar only to naming a state as a party. The substantive impact of the amendment is no broader than a restatement of traditional rules surrounding the proper role of a court of equity. In damage actions against individual officers, the amendment itself has no direct impact.

McCormack, *Federalism and Section 1983: Limitations of Judicial Enforcement of Constitutional Protections, Part I*, 60 VA. L. REV. 1, 48 (1974).

[32] [T]he real question is not whether that defendant is 'immune' from suit . . . . Rather, the relevant inquiry is whether a local unit of government is a "person" within the meaning of the Civil Rights Act . . . .

Dodd v. Spokane County, 393 F.2d 330, 334 (9th Cir. 1968).

[33] 209 U.S. 123 (1908).

[34] *Id.* at 159-60. For a general discussion of the history and scope of the eleventh amendment see Note, *A Practical View of the Eleventh Amendment—Lower Court Interpretations and the Supreme Court's Reaction*, 61 GEO. L.J. 1473 (1973).

[35] *See, e.g.*, Burt v. Board of Trustees, 521 F.2d 1201 (4th Cir. 1975); Incarcerated Men of Allen County Jail v. Fair, 507 F.2d 281 (6th Cir. 1974); United Farmworkers of

permissible remedies to declaratory and prospective, rather than mandatory, relief[36] on the theory that those forms do not impose monetary burdens on the entity concerned.[37] These courts apparently use a rationale[38] similar to that employed by the Supreme Court in *Edelman v. Jordan*.[39] Although it was an eleventh amendment case, *Edelman's* reasoning may logically be applied to section 1983 cases to prevent plaintiffs from accomplishing indirectly that which cannot be done directly.[40] In *Edelman*, the Court disallowed a retroactive award of wrongfully withheld state benefits made as part of an equitable remedy. The Court reasoned that since the recovery sought would stem from the state treasury, the suit was, in essence, against the state and thus barred by the eleventh amendment, even though the state was not a party to the action.[41] Application

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Fla. Housing Project, Inc. v. City of Delray Beach, 493 F.2d 799 (5th Cir. 1974); Paxman v. Wilkerson, 390 F. Supp. 442 (E.D. Va. 1975).

[36] *See* Adams v. City of Park Ridge, 293 F.2d 585 (7th Cir. 1961) (reasons prohibiting monetary awards do not apply to declaratory and injunctive relief); Hogge v. Hedrick, 391 F. Supp. 91 (E.D. Va. 1975); O'Brien v. Galloway, 362 F. Supp. 901 (D. Del. 1973).

[37] Adams v. City of Park Ridge, 293 F.2d 585 (7th Cir. 1961), seems to have generated the theory. Decided shortly after *Monroe*, *Adams* involved only declaratory and injunctive relief. The court held:

> The facts in Monroe v. Pape suggests [*sic*] several inherent reasons for excluding municipalities from [section 1983] liability for damages, such as unauthorized misconduct of the officers, lack of power of city [*sic*] to indemnify plaintiffs for such misconduct, and a city's governmental immunity . . . . None of the reasons which support a city's immunity from an action for damages . . . applies to this case.

Id. at 587. *See generally* 53 N.C.L. Rev. 439 (1974).

[38] This rationale was accurately stated by the Supreme Court of the United States in 1902:

> [W]hether a suit is one against a state is to be determined, not by the fact of the party named as defendant on the record, but by the result of the judgment or decree which may be entered . . . .

Minnesota v. Hitchcock, 185 U.S. 373, 387 (1902).

[39] 415 U.S. 651 (1974).

[40] *See* Needleman v. Bohlen, 386 F. Supp. 741, 745 (D. Mass. 1974).

[41] 415 U.S. at 677; *accord*, Ford Motor Co. v. Department of Treasury, 323 U.S. 459 (1945); Rothstein v. Wyman, 467 F.2d 226 (2d Cir. 1972), *cert. denied*, 411 U.S. 921 (1973); Westberry v. Fisher, 309 F. Supp. 12 (D. Me. 1970). Where suits are brought against local governmental bodies, however, eleventh amendment problems are not encountered. Municipalities and counties have consistently been held to be distinct from the states and therefore unable to enjoy eleventh amendment immunity. Edelman v. Jordan, 415 U.S. 651, 667 n.12 (1974); Lincoln County v. Luning, 133 U.S. 529 (1890); Markham v. City of Newport News, 292 F.2d 711 (4th Cir. 1961); Bennett v. Gravelle, 323 F. Supp. 203 (D. Md. 1971). Footnote 12 in *Edelman* reads:

> [A]s may be seen from Griffin's citation of Lincoln County v. Luning, 133 US 529 . . . (1890), a county does not occupy the same position as a State for purposes of the Eleventh Amendment. See also Moor v. County of Alameda, 411 US 693 . . . (1973). The fact that the county policies executed by the county officials in Griffin were subject to the commands of Fourteenth Amendment, but the county was not able to invoke the protection of the Eleventh Amendment, is no more than a recognition of the long-established rule that while county

of the eleventh amendment rationale to section 1983 cases, however, has resulted in confusion. Under one theory, if the relief sought would impinge on the municipal treasury, the suit is essentially against the nonperson governmental entity and thus not within the ambit of section 1983.[42] Other courts have allowed equitable relief in section 1983 suits against municipal officials, sued in their official capacity, "even if it would have a severe impact on local governments . . . ."[43] Employing a persuasive rationale, the Fifth Circuit, in *Harkless v. Sweeny Independent School District*,[44] ruled that back pay awards could be assessed against municipal agencies under section 1983 since such awards constitute an "integral part of the equitable remedy of injunctive reinstatement."[45]

It is clear that officials—in their individual capacities—are "persons" within the meaning of section 1983. To hold otherwise would suggest the impossibility of a section 1983 action against any government official or employee. *Kenosha* does not require or even intimate the possibility of this result. To recover damages, however, a plaintiff must establish that the defendant acted in bad faith in performing his official duties to deprive the plaintiff of a constitutional right.[46] The individual's actions must be such as "cannot reasonably be

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action is generally state action for purposes of the Fourteenth Amendment, a county defendant is not necessarily a state defendant for purposes of the Eleventh Amendment.

415 U.S. at 667 n.12.

[42] *E.g.*, Patton v. Conrad Area School Dist., 388 F. Supp. 410, 417 (D. Del. 1975), *citing* Hayes v. Cape Hendopen School Dist., 341 F. Supp. 823, 829 (D. Del. 1971). *See also* Bennet v. Gravelle, 323 F. Supp. 203, 211 (D. Md. 1971), *aff'd on other grounds*, 451 F.2d 1011 (4th Cir.), *cert. dismissed*, 407 U.S. 917 (1972):

> In their official capacities, the [municipal officials] are extensions of the municipal agency and are, therefore, not "persons" within the meaning of section 1983. Accordingly damages may not be assessed against the defendants under this section for acting in their official capacities.

323 F. Supp. at 211.

[43] Incarcerated Men of Allen County Jail v. Fair, 507 F.2d 281, 288 (6th Cir. 1974); *accord*, Burt v. Board of Trustees, 521 F.2d 1201, 1205 (4th Cir. 1975); United Farmworkers of Fla. Housing Project, Inc. v. City of Delray Beach, 493 F.2d 799, 802 (5th Cir. 1974); Harper v. Kloster, 486 F.2d 1134, 1138 (4th Cir. 1973). In *Delray Beach* the Fifth Circuit held that section 1983 actions can proceed against individual party defendants despite the fact that the ultimate judgment would "surely be felt by the city." 493 F.2d at 802.

[44] 427 F.2d 319 (5th Cir. 1970), *cert. denied*, 400 U.S. 991 (1971).

[45] *Id.* at 324.

[46] O'Connor v. Donaldson, 422 U.S. 563 (1975); Wood v. Strickland, 420 U.S. 308 (1975); Scheuer v. Rhodes, 416 U.S. 232 (1974); Pierson v. Ray, 386 U.S. 547 (1966). *Pierson* and subsequent immunity cases have served as a springboard for the proposition that all public officials should be given protection in the good faith execution of their discretionary duties. This position is based upon the policy that public officials should not be badgered by suits or held financially responsible for unavoidable judgment errors and resulting injuries. *See, e.g.*, Collins v. Schoonfield, 363 F. Supp. 1152 (D. Md. 1973)(jail officials); O'Brien v. Galloway, 362 F. Supp. 901 (D. Del. 1973)(town commissioners). The extent of protection under a good faith defense has been defined as varying with "the scope of discretion and . . . the circumstances as they reasonably appeared" at the time. Scheuer v. Rhodes, 416 U.S. 232, 247 (1974). Since a good faith defense is

characterized as being in good faith."[47] Moreover, the official "cannot be charged with the responsibility of predicting the future course of constitutional law."[48]

In the instant case, the court reasoned that since the pension fund board was so closely related to the municipality that it became an arm of the city, it was not a "person" within the scope of section 1983.[49] The court further reasoned that since granting plaintiffs' claims for an accounting, restitution, and refunds against the officials would ultimately amount to a recovery from public resources in the pension fund, and not from the officials' personal resources, the court lacked jurisdiction to award the requested relief. Such a recovery was precluded by *Monroe's* and *Moor's* holdings that "Congress did not intend . . . to impose vicarious liability on municipalities for violations of federal civil rights by their employees."[50] The court emphasized that since the suit was, in essence, not against the nominal defendants but against the unnamed board over which no jurisdiction existed, the decision did not mean that jurisdiction varied with the nature of the relief to be granted. Consequently, the court rejected the assertion[51] that jurisdiction for purposes of declaratory and injunctive relief would lie against the individual defendants. The court concluded that since the no-refund provision was prohibitory in nature, a declaration of unconstitutionality or an injunction preventing its enforcement would be tantamount to holding that plaintiffs were entitled to their claims for monetary recovery from the fund. Thus, the court lacked jurisdiction under sections 1983 and 1343(3).[52]

Judge Tuttle, in a dissenting opinion,[53] asserted that since Congress did not intend the meaning of the word "person" to vary with the effect a judgment might have on municipal funds, the majority had misinterpreted the statute with the result being the grant of municipal immunity. Judge Tuttle contended that the scope of section 1983 simply did not extend so far as to encompass municipal corporations. Citing several post-*Kenosha* decisions which allowed equitable monetary relief against subdivisions of municipal entities[54] and indi-

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often difficult for a plaintiff to overcome, the likelihood of his obtaining a personal monetary judgment is greatly diminished. For a discussion of limited immunities and the good faith defense see 53 N.C.L. Rev. 439 (1974).

[47] Wood v. Strickland, 420 U.S. 308, 322 (1975).

[48] Tucker v. Maher, 497 F.2d 1309 (2d Cir. 1974).

[49] Muzquiz v. City of San Antonio, 528 F.2d 499, 500 (5th Cir. 1976)(adopting Judge Godbold's panel dissent pro tanto).

[50] 520 F.2d at 1007 (Godbold, J., dissenting in part from panel opinion), *quoting* Moor v. County of Alameda, 411 U.S. 693, 710 n.27 (1973).

[51] 520 F.2d at 1002-03.

[52] Chief Judge Brown submitted an opinion which indicated that he did not view *Muzquiz* as foreclosing the possibility of section 1983 suits for declaratory or injunctive relief which would not directly affect the public fisc. 528 F.2d at 501 (Brown, C. J., dissenting and concurring in part).

[53] *Id.* at 501 (Tuttle, J., dissenting)(joined by Judges Wisdom, Goldberg, and Morgan). Judge Thornberry concurred in Judge Tuttle's assertion that the individual officials were "persons" under the statute. *Id.* at 503 (Thornberry, J., concurring in part and dissenting in part).

[54] *Id.* at 502 (Tuttle, J., dissenting), *citing* Bradley v. School Bd., 416 U.S. 696 (1974),

vidual officials,[55] he concluded that the individual members of the board, as officials, were "persons" and amenable to suit under section 1983.[56]

Judge Godbold,[57] concurring in part and dissenting in part, contended that since *Monroe* was merely a protection of municipal funds from damage awards, and since *Kenosha* did not broaden that protection in terms of "insulating public funds from the impact of non-damage claims,"[58] the court had jurisdiction over the equitable claim for restitution. According to Judge Godbold, the protection afforded a municipality by *Monroe* and *Kenosha* is limited to those suits in which a plaintiff seeks damages against a municipality; therefore, that protection does not extend to equitable claims merely because they affect a public treasury.

The instant case severely limits the ability to obtain equitable relief, ordinarily available under section 1983, if the relief will have some financial impact on the public fisc. Artificial limitations should not be imposed simply because some forms of equitable relief more obviously affect the municipality than others. Although a section 1983 plaintiff should not be allowed to clothe his damage suit in the guise of an equitable claim for declaratory and injunctive relief, bona fide equitable claims for back pay, reinstatement, or restitution should be allowed. Other forms of equitable relief, left largely unaddressed in *Muzquiz*, are often inadequate to fully compensate deprivations of constitutional rights.[59] *Thurston v. Dekle*,[60] a Fifth Circuit case subsequent to *Muzquiz*, indicates that equitable claims which will not affect public funds will continue to be permissible. Yet, the number of possible section 1983 claims has been considerably reduced. Lower courts which have allowed equitable monetary relief against officials have traditionally relied upon footnote 12 in *Edelman*;[61] however, the instant court apparently did not consider the note useful. Consequently, the value of the footnote, at least in the Fifth Circuit, is questionable.[62] In an effort

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and Davis v. Board of School Comm'rs, 526 F.2d 865 (5th Cir. 1976).

[55] 528 F.2d at 499 (Tuttle, J., dissenting), *citing* Burt v. Board of Trustees, 521 F.2d 1201 (4th Cir. 1975).

[56] I see no valid distinction between the impact on local funds caused by jail reform suits, reinstatement and back pay suits, school desegregation suits and the impact on the pension fund that a restitutionary award here would cause.

528 F.2d at 503 n.2 (Tuttle, J., dissenting).

[57] 528 F.2d at 504 (Godbold, J., concurring in part and dissenting in part).

[58] *Id.*

[59] *See* Kates & Kouba, *supra* note 18, at 137.

[60] 531 F.2d 1264 (5th Cir. 1976). *Thurston* was a section 1983 suit against city officials for allegedly wrongful dismissal. The court held that even though the lower court decision preceded *Muzquiz*, the district court lacked subject matter jurisdiction as a result of *Muzquiz*. The court did, however, because of the unique facts presented by *Thurston*, proceed to the merits. *Id.* at 1271.

[61] 415 U.S. 651, 667 n.12 (1974). See notes 38 through 45 and accompanying text *supra*.

[62] In addition, it should be noted that Harkless v. Sweeney Independent School Dist., 427 F.2d 319 (5th Cir. 1970), which is in direct conflict with the holding in *Muzquiz* and was not overruled by the court, was again ignored by the court in *Thurston*. It appears,

to foreclose the possibility that damage awards might be entered against individuals in their official capacities and enforced against the public fisc, the court went considerably further than the problem dictated. Fifth Circuit and other lower court decisions allowing equitable or injunctive relief such as reinstatement and back pay are virtually indistinguishable from *Muzquiz*. The awards in all of these cases would have some impact on public funds.

The instant case may cause problems in the Fifth Circuit for plaintiffs—for example, schoolteachers—who obtained equitable monetary judgments in a district court against officials prior to *Muzquiz*. It is possible that those school officials who have not yet compensated the teachers will choose to ignore the judgment against them, claiming that the district court lacked jurisdiction to entertain the suit. The result is uncertain, but *Thurston*[63] indicates that *Muzquiz* will be given retroactive effect. The parallel between *Muzquiz* and back pay-reinstatement cases goes beyond their similar impact on public funds. Neither back pay nor restitutionary relief can be effectuated by the individual members of a board. Relief of this nature can be implemented only if the board members act as an entity, which is a "non-person" under section 1983 and, therefore, immune from suit. Again the plaintiff is denied recovery. Given the binding effect of *Muzquiz* in the Fifth Circuit, the question remains: How may a post-*Muzquiz* plaintiff obtain federal jurisdiction when seeking relief for deprivation of constitutional rights?

The hypothetical case of schoolteachers who allege wrongful dismissal illustrates the courses of action open to the post-*Muzquiz* plaintiff. The plaintiff teacher, of course, is barred by the *Monroe, Moor,* and *Kenosha* decisions from bringing a section 1983 action against the city or county involved. The plaintiff might name the school board as defendant and argue that it is not an arm of the state and is, therefore, a "person" under section 1983. This approach is weakened, however, by abundant case law to the contrary.[64] Plaintiff might also argue that the funds from which he seeks recovery are not public money; but in the school cases it is doubtful that the court would favor this view since public schools are directly supported by the government. Plaintiff's only other option in seeking restitution and back pay under section 1983 is a suit against the individual officials. This course of action is not promising, however, since he must prove that the defendant acted in bad faith.[65] Even if plaintiff succeeds in procuring a personal judgment, he has no assurance that the official will be solvent.

A plaintiff to whom the possibility of equitable monetary recovery under sections 1983 and 1343(3) appears unlikely would, perhaps, be wise to seek his remedy under an alternative statute. Most successful have been suits resorting to section 1331, under which the plaintiff may recover damages for constitutional torts. Since section 1331 is not limited by the term "person," a plaintiff

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therefore, that the court intends to continue to bar suits seeking restitution and back pay without regard to its holding in *Harkless*.

[63] 531 F.2d 1264, 1269 (5th Cir. 1976).

[64] See note 25 *supra*.

[65] See notes 46 through 48 and accompanying text *supra*.

resting jurisdiction on this statute may presumably sue the municipality and the board in addition to the individual officials. The leading case recognizing constitutional torts and a resultant cause of action against governmental officials is *Bivens v. Six Unknown Named Federal Narcotics Agents*.[66] Since *Bivens*, lower federal courts have allowed suits deriving a cause of action from constitutional deprivations with section 1331 as a jurisdictional base.[67] The prevailing view, however, has been that the plaintiff must still establish the amount-in-controversy as a jurisdictional prerequisite "even in cases in which fundamental constitutional rights are at stake, however difficult of valuation such rights may be."[68]

One interesting theory suggests that section 1983's jurisdictional counterpart, section 1343(3), may be utilized in conjunction with a cause of action stemming "directly under the United States Constitution rather than section 1983."[69] Although this theory is not yet accepted by the courts, section 1343(3) appears to specifically grant jurisdiction for such a cause of action:

> The district courts shall have original jurisdiction of any civil action authorized by law to be commenced by any person:
>
> . . . .
>
> (3) To redress the deprivation, under color of any State law, statute, ordinance, regulation, custom or usage, of any right, privilege or immunity secured by the Constitution of the United States or by any Act of Congress providing for equal rights of citizens or of all persons within the jurisdiction of the United States.[70]

Thus, by employing section 1343(3) and basing the cause of action directly upon the Constitution, both the "person" restriction of section 1983 and the jurisdictional amount requirement of section 1331(a) could be effectively sidestepped. When the nonavailability of money judgments to section 1983 plaintiffs against municipalities, the limited availability of recovery against individuals, and the holding in *Muzquiz* are examined in combination, it appears that the Fifth Circuit has virtually eliminated the likelihood of any type of monetary

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[66] 403 U.S. 388 (1971).

[67] *E.g.*, Reeves v. City of Jackson, 532 F.2d 491, 495 (5th Cir. 1976); Demkowicz v. Endry, 411 F. Supp. 1184 (S.D. Ohio 1975). *See also* Marquez v. Hardin, 339 F. Supp. 1364 (N.D. Cal. 1969)(injunction); Cortright v. Resor, 325 F. Supp. 797 (E.D.N.Y.), *rev'd on other grounds*, 447 F.2d 245 (2d Cir. 1971) (damages); *cf.* Brault v. Town of Milton, 527 F.2d 730 (2d Cir. 1975).

[68] King v. Morton, 520 F.2d 1140, 1145 (D.C. Cir. 1975). *See generally* Horlbeck & Harkness, *Executive Immunity and the Constitutional Tort*, 51 DENVER L.J. 321 (1974); Note, *Measuring Damages for Violations of Individuals' Constitutional Rights*, 8 VAL. L. REV. 357 (1974).

[69] Bodensteiner, *Federal Court Jurisdiction of Suits Against "Non-Persons" for Deprivations of Constitutional Rights*, 8 VAL. L. REV. 215, 216-17 (1974).

An additional alternative is a suit for back pay and reinstatement under 42 U.S.C. § 1981 with 28 U.S.C. § 1343(3) serving as the jurisdictional base. Campbell v. Godsen County Dist. School Bd., No. 75-1998 (5th Cir. July 2, 1976).

[70] 28 U.S.C. § 1343(3)(1970).

recovery under section 1983—a result which seems to be contrary to the policy underlying the statute.[71] Whether *Muzquiz* is an attempt to lighten the increasingly heavy load of section 1983 cases or whether it is simply an exaggerated move to "close off this end run around *Monroe*,"[72] the court, as Justice Tuttle contended, seems to have "whittled down the clear statutory grant of civil rights litigation under color of state law to little more than an empty promise."[73]

S. Allan Alexander
Fred Krutz III

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[71] See note 16 *supra*.

[72] Muzquiz v. City of San Antonio, 528 F.2d at 505 (Godbold, J., concurring in part and dissenting in part).

[73] *Id.* at 501 (Tuttle, J., dissenting).

CIVIL RIGHTS—SECTION 1983 DAMAGES—PROSECUTOR HAS ABSOLUTE IMMUNITY FROM CIVIL LIABILITY FOR ACTS COMMITTED WITHIN THE SCOPE OF HIS DUTIES

Appellant, Paul Kern Imbler, filed suit[1] in the United States District Court for the Central District of California against Deputy District Attorney Richard Pachtman[2] seeking damages for the alleged deprivation of his constitutional rights. Imbler had been successfully prosecuted for murder by Pachtman[3] and sentenced to prison. Following his release on a writ of habeas corpus,[4] Imbler brought suit contending that Pacthman had knowingly used false testimony and had suppressed material evidence in obtaining his conviction. The district court, holding that public prosecutors are immune from civil liability for "acts done as part of their traditional official function," dismissed the complaint.[5] The United States Court of Appeals for the Ninth Circuit affirmed.[6] On certiorari to the United States Supreme Court, *held*, affirmed. A state prosecuting attorney who is acting within the scope of his official duties is absolutely immune from a section 1983 suit for damages. *Imbler v. Pachtman*, 96 S. Ct. 984 (1976).

Judicial immunity has been firmly embedded in the English common law since 1607.[7] The doctrine is based upon the policy that "[a judge's] errors may

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[1] Appellant based his action on 42 U.S.C. § 1983 (1970), which provides:

> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

Jurisdiction of the district court was invoked under 28 U.S.C. § 1343(3).

[2] Also joined as parties defendant were various officers of the Los Angeles police force. Imbler v. Pachtman, 96 S. Ct. 984, 988 (1976).

[3] Imbler was convicted of murder in 1962 and sentenced to death. The conviction was unanimously affirmed by the Supreme Court of California. California v. Imbler, 57 Cal. 2d 711, 371 P.2d 304, 21 Cal. Rptr. 568 (1962). Subsequently, Imbler's death sentence was reduced to life imprisonment. *In re* Imbler, 61 Cal. 2d 556, 393 P.2d 687, 39 Cal. Rptr. 375 (1964).

[4] Pachtman wrote to the Governor of California describing new evidence which tended to indicate Imbler's innocence. On the basis of this new evidence Imbler filed a habeas corpus petition in state court, contending that the prosecution had "knowingly used false testimony and suppressed material evidence at Imbler's trial." Imbler v. Pachtman, 96 S. Ct. 984, 987 (1976). The California Supreme Court rejected these contentions and denied the writ. *In re* Imbler, 60 Cal. 2d 554, 387 P.2d 61, 35 Cal. Rptr. 293 (1963). Imbler then filed a habeas corpus petition in federal district court based on the same allegations previously rejected by the California Supreme Court. The district court, confining its examination to the record, found that the prosecution had made culpable use of false or misleading evidence and issued the writ when the state of California refused to re-try Imbler. Imbler v. Craven, 298 F. Supp. 795 (C.D. Calif. 1969), *aff'd sub nom.*, Imbler v. California, 424 F.2d 632 (9th Cir.), *cert. denied*, 400 U.S. 865 (1970).

[5] Imbler v. Pachtman, 96 S. Ct. 984, 988 (1976). The district court did not release an opinion.

[6] Imbler v. Pachtman, 500 F.2d 1301 (9th Cir. 1975), *aff'd*, 96 S. Ct. 984 (1976).

[7] The case of Floyd & Barker, 77 Eng. Rep. 1305 (Star Chamber 1607), was the first

be corrected on appeal, but he should not have to fear that unsatisfied litigants may hound him with litigation charging malice or corruption."[8] At the time Section 1 of the Civil Rights Act of 1871[9] was adopted, a majority of the American jurisdictions which had ruled on the issue provided an absolute immunity to judges.[10] The Supreme Court adopted this view in 1872 in the case of *Bradley*

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case to state the doctrine that judges were absolutely immune from civil liability for acts committed in their judicial role. This rule has been consistently followed in England when applied to judges of the superior courts, *see* Taaffe v. Downes (1813), *reported in* Calder v. Halket, 13 Eng. Rep. 12, 15 n.*(a)* (P.C. 1839), though justices of the peace have been held liable when they acted maliciously. Comment, *Liability of Judicial Officers Under Section 1983*, 79 YALE L.J. 322, 325 (1969), *citing* THE JUSTICES PROTECTION ACT, 11 & 12 Vict. ch. 44 (1848), *and* Burley v. Bethune, 5 Taunt. 580 (C.P. 1814).

[8] Pierson v. Ray, 386 U.S. 547, 554 (1967). This policy has been justified on the basis that

> it is impossible to know whether the claim is well founded until the case has been tried, and that to submit all officials, the innocent as well as the guilty, to the burden of a trial and to the inevitable danger of its outcome, would dampen the ardor of all but the most resolute, or the most irresponsible, in the unflinching discharge of their duties.

Martone v. McKeithen, 413 F.2d 1373, 1375 (5th Cir. 1969), *quoting* Gregoire v. Biddle, 177 F.2d 579, 581 (2d Cir. 1949).

Other justifications advanced are:

> (1) preventing threat of suit from influencing decisions; (2) protecting judges from liability for honest mistakes; (3) relieving judges of the time and expense of defending suits; (4) removing an impediment to responsible men entering the judiciary; (5) necessity of finality; (6) appellate review is satisfactory remedy; (7) the judge's duty is to the public and not the individual; (8) judicial self-protection; (9) separation of powers.

Pierson v. Ray, *supra*, at 564 n.4 (Douglas, J., dissenting).

[9] 42 U.S.C. § 1983 (1970), *formerly* ch. 22, § 1, 17 Stat. 13 (1871). See note 1 *supra*.

[10] Hamilton v. Williams, 26 Ala. 527 (1855) (probate judge held immune from civil liability for omitting to take security from a guardian); Borden v. Arkansas, 11 Ark. 519, 537 (1851) ("[T]he judges of the superior courts are never to be made liable either by civil proceedings or by indictment for any thing done by them in a judicial capacity."); Downer v. Lent, 6 Cal. Rep. 94, 96 (1856) (quasi-judicial body—Board of Pilot Commissioners); Holcomb v. Cornish, 8 Conn. 375, 381 (1831) (absolute immunity where judge has jurisdiction); Bailey v. Wiggins, 1 Houst. 299, 306-07 (Del. 1856) (no civil action where judge has jurisdiction: "He may be impeached . . . and may be removed from office . . ." in another form.), *citing* Yates v. Lansing, 5 Johns 282 (N.Y. Sup. Ct. of Judicature 1810) (malicious prosecution); Pratt v. Gardner, 56 Mass. 63 (1849)(justice of the peace); Lenox v. Grant, 8 Mo. 254, 255 (1843)(justice of the peace immune if acting within his sphere of office, even if actions are corrupt); Burnham v. Stevens, 33 N.H. 247, 253 (1856) judge immune unless he "has assumed to act as [judge] in a case where he has no jurisdiction . . . ."); Little v. Moore, 4 N.J.L. 74, 75 (1818)("[I]n courts of general jurisdiction an action never lies against the judge, because he has jurisdiction of all causes; in courts of limited jurisdiction, it lies only when he exceeds that jurisdiction, and therefore is not in the exercise of his judicial authority."); Cunningham v. Dillard, 20 N.C. 485, 487 (1839)(judge immune if within jurisdiction, "however erroneous his decision, or malicious the motive imputed to him"); Druecker v. Salomon, 21 Wis. 628, 630 (1867)(public officers immune if act is discretionary; liable if act is merely ministerial).

v. Fisher.[11] In *Bradley*, an attorney, deprived of his right to practice law, brought an action for damages allegedly sustained as a result of the wilful, malicious, and oppressive acts of the judge. The Court, per Mr. Justice Field, held that judges were absolutely immune from liability for acts in "excess of jurisdiction," but could be held liable in "the clear absence of all jurisdiction over the subject-matter."[12] With the doctrine of judicial immunity thus well established in

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The entire area of immunities was succinctly stated by the Supreme Court of Virginia:

> By the common law, judges or justices of the peace, acting judicially, while keeping within the limits of their jurisdiction, are not responsible to civil actions, however gross their misbehavior or improper their motives. But ministerial officers are liable for injuries proceeding from their unlawful acts or omissions, though attributable only to ignorance or mistake. Ministerial officers, however, and other public officers, though not employed in the administration of justice, when called upon by law to exercise a deliberative judgment, are not responsible for errors of judgment, in the absence of all corruption or malice.

Austin v. Richardson, 42 Va. 310, 322 (1844).

A few states did not grant an absolute immunity, although they did grant a qualified immunity based on an actual malice standard. Indiana *ex rel.* Conley v. Flinn, 3 Blackf. 72, 74 (Ind. 1832) (justice of the peace liable only where "he has acted from impure or corrupt motives"); Gregory v. Brown, 7 Ky. (4 Bibb.) 28, 29 (1815)(no liability unless magistrate "has acted from impure or corrupt motives"); Reid v. Hood, 2 Nott & McC. 168, 171 (S.C. 1819) (liability when a judge acts "wilfully"); Hoggatt v. Bigley, 25 Tenn. (6 Humphreys) 236 (1845)(no liability if judge acts without malice).

> [A] judicial officer is not liable civilly for *judicial* acts, unless it may be (a point on which the authorities are not in accord) where he acts willfully, maliciously, or corruply, [*sic*]. . . . And these authorities show that this exemption from civil responsibility extends to all public officers who are charged with deciding upon matters of a *quasi* judicial nature . . . . The ground of this exemption is that the public good can best be secured by allowing officers charged with the duty of deciding upon the rights of others, "to act upon their own free, unbiased convictions, uninfluenced by any apprehensions."

Wasson v. Mitchell, 18 Iowa 153, 155-56 (1864).

[11] 80 U.S. (13 Wall.) 335 (1872).

[12] *Id.* at 351. In reaching this conclusion the Court overruled dictum in Randall v. Brigham, 74 U.S. (7 Wall.) 523, 536 (1868), which stated that judges were immune except "where the acts, in excess of jurisdiction, are done maliciously or corruptly." 80 U.S. (13 Wall.) at 351. See Comment, *supra* note 7, at 326.

Illustrating the distinction between acts in the clear absence of jurisdiction and acts in excess of jurisdiction, the Court in *Bradley* stated:

> Thus, if a probate court, invested only with authority over wills and the settlement of estates of deceased persons, should proceed to try parties for public offenses, jurisdiction over the subject of the offenses being entirely wanting in the court, and this being necessarily known to its judge, his commission would afford no protection to him in the exercise of his usurped authority. But if on the other hand a judge of a criminal court, invested with general criminal jurisdiction over offenses committed within a certain district, should hold a particular act to be a public offense, which is not by the law made an offense, and proceed to the arrest and trial of a party charged with such an act, or should sentence a party convicted to a greater punishment than that authorized by the law upon its proper construction, no personal liability to civil action for such

Anglo-American jurisprudence, states began to afford an immunity to quasi-judicial officers from suits for defamation,[13] false imprisonment,[14] and malicious prosecution.[15] Federal courts followed this lead and granted the immunity where the action was not based on section 1983.[16] In the first case to consider the

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acts would attach to the judge, although those acts would be in excess of his jurisdiction, or of the jurisdiction of the court held by him, for these are particulars for his judicial consideration, whenever his general jurisdiction over the subject-matter is invoked.

80 U.S. (13 Wall.) at 352.

[13] *E.g.*, Griffith v. Slinkard, 146 Ind. 117, 44 N.E. 1001 (1896) (Prosecuting attorney is a judicial officer and thus is not liable civilly in an action for libel for procuring a wrongful indictment.).

[14] *Cf.* Schneider v. Shepherd, 192 Mich. 82, 158 N.W. 182 (1916)(prosecutor liable in action for false imprisonment where he acts outside the line of his public duty).

[15] *Absolute immunity: E.g.*, Pearson v. Reed, 6 Cal. App. 2d 277, 44 P.2d 592 (1935)(city prosecutor not liable for prosecution carried on maliciously and without probable cause); McDonald v. Lakewood Country Club, 170 Colo. 355, 461 P.2d 437, 441 (1969) (immune if acting in official capacity); Jaffarian v. Murphy, 280 Mass. 402, 183 N.E. 110 (1932) (Quasi-judicial official acting within the scope of his authority is immune.); Robinette v. Price, 214 Minn. 521, 8 N.W.2d 800, 807 (1943)("A public officer whose functions are judicial or quasi-judicial is not liable to persons injured by the honest exercise of his judgment within his jurisdiction, however erroneous his judgment may be."); Feuchter v. City of St. Louis, 357 Mo. 616, 210 S.W.2d 21, 25 (1948)(not liable for error of judgment); Sweeney v. Young, 82 N.H. 159, 131 A. 155 (1925)(immune, regardless of motives); Kittler v. Kelsch, 56 N.D. 227, 216 N.W. 898 (1927)(state's attorney held immune where he passes on the sufficiency of the evidence with regard to prosecution); Watts v. Gerking, 111 Ore. 641, 228 P. 135 (1924)(prosecutor who suborns or commits perjury is subject to criminal sanctions, but not to civil liability); Dunbar v. Fant, 170 S.C. 414, 170 S.E. 460 (1933)(immune for discretionary acts, but not for ministerial ones); Anderson v. Manley, 181 Wash. 327, 43 P.2d 39, 40 (1935)(immune if within authority, even if acting with malice and without probable cause).

Qualified immunity: E.g., Leong Yan v. Carden, 23 Haw. 362, 369 (1916)(prosecutor liable if he prosecutes without probable cause and with malice); Allen v. Miller, 142 Neb. 469, 6 N.W.2d 594, 598 (1942)(quasi-judicial immunity for discretionary acts within the scope of his authority, and without malice, wilfullness, or corruption); *cf.* Barnett v. Lollar, 197 Miss. 574, 579, 19 So. 2d 748, 749 (1944)(public officer not liable "for errors or mistakes made by him in good faith when acting judicially or quasi judicially within the scope of the subject matter over which he has been given jurisdiction").

[16] The first case to so hold, Yaselli v. Goff, 12 F.2d 396, 404 (2d Cir. 1926), *noted in* 40 HARV. L. REV. 324 (1926); 6 BOST. U.L. REV. 280 (1926), citing only state court cases, stated in an action for malicious prosecution: "The reasons for granting immunity to judges, jurors, attorneys, and executive officers of the government apply to a public prosecutor in the performance of the duties which rest upon him." 12 F.2d at 404. The court in *Yaselli* granted the immunity where the action was instituted with malice and without probable cause.

Other cases holding that a prosecutor is a quasi-judicial official who is immune from suit when acting within the scope of his duties include: Boyd v. Adams, 513 F.2d 83 (7th Cir. 1975); Apton v. Wilson, 506 F.2d 83 (D.C. Cir. 1974); Weathers v. Ebert, 505 F.2d 514 (4th Cir. 1974); Duba v. McIntyre, 501 F.2d 590 (8th Cir. 1974); McLallen v. Henderson, 492 F.2d 1298 (8th Cir. 1974); Barnes v. Dorsey, 480 F.2d 1057 (8th Cir. 1973);

section 1983 immunity issue, however, the Third Circuit, in *Picking v. Pennsylvania R.R.*,[17] held that Congress *did* intend section 1983 to abrogate the common law immunities.[18] The United States Supreme Court, initially considering the issue in *Tenney v. Brandhove*,[19] took the opposite position, holding that legislators retained their traditional common law immunity under section 1983.[20] This holding was reinforced in 1961 when the Court stated in *Monroe v. Pape*[21] that section 1983 "should be read against the background of tort liability that makes a man responsible for the natural consequences of his actions."[22] With the advent of *Tenney* and *Monroe*, the federal courts of appeals retreated from their previous positions, recognizing that judicial immunity was not abolished by the Civil Rights Act of 1871.[23] The Supreme Court sanctioned the retreat in *Pierson v. Ray*,[24] wherein the Court held that judges were immune from liability for damages under section 1983 for acts committed within the scope of their judicial role, regardless of malice or corruption.[25] The First,[26] Second,[27] Fourth,[28] and

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Cambist Films, Inc. v. Duggan, 475 F.2d 887 (3d Cir. 1973); Turack v. Giudo, 464 F.2d 535 (3d Cir. 1972); United States *ex rel.* Moore v. Koelzer, 457 F.2d 892 (3d Cir. 1972); Madison v. Gerstein, 440 F.2d 338 (5th Cir. 1971); Guedry v. Ford, 431 F.2d 660 (5th Cir. 1970); Arensman v. Brown, 430 F.2d 190 (7th Cir. 1970); Berg v. Cwiklinski, 416 F.2d 929 (7th Cir. 1969); Madison v. Purdy, 410 F.2d 99 (5th Cir. 1969); Kalec v. Adamowski, 406 F.2d 536 (7th Cir. 1969); Marlowe v. Coakley, 404 F.2d 70 (9th Cir. 1968), *cert. denied*, 395 U.S. 947 (1969); Skolnick v. Hanrahan, 398 F.2d 25 (7th Cir. 1968); Stiltner v. Rhay, 371 F.2d 420 (9th Cir.), *cert. denied*, 386 U.S. 997 (1967); Bauers v. Heisel, 361 F.2d 581 (3d Cir. 1966), *cert. denied*, 386 U.S. 1021 (1967); Kostal v. Stoner, 292 F.2d 492 (10th Cir. 1961); Smith v. Dougherty, 286 F.2d 777 (7th Cir.), *cert. denied*, 368 U.S. 903 (1961); Thompson v. Heither, 235 F.2d 176 (6th Cir.), *appeal dismissed*, 352 U.S. 921 (1956); Kenney v. Fox, 232 F.2d 288 (6th Cir.), *cert. denied*, 352 U.S. 855 (1956); Francis v. Crafts, 203 F.2d 809 (1st Cir.), *cert. denied*, 346 U.S. 835 (1953); Patten v. Dennis, 134 F.2d 137 (9th Cir. 1943).

[17] 151 F.2d 240 (3d Cir. 1945).

[18] *Id.* at 250; *accord*, McShane v. Moldovan, 172 F.2d 1016 (6th Cir. 1949); Burt v. City of New York, 156 F.2d 791 (2d Cir. 1946).

[19] 341 U.S. 367 (1951).

[20] *Id.*

[21] 365 U.S. 167 (1961).

[22] *Id.* at 187.

[23] Bauers v. Heisel, 361 F.2d 581 (3d Cir. 1966), *overruling* Picking v. Pennsylvania R.R., 151 F.2d 240 (3d Cir. 1945); Fanale v. Sheehy, 385 F.2d 866 (2d Cir. 1966); Cuiksa v. City of Mansfield, 250 F.2d 700 (6th Cir. 1957), *cert. denied*, 356 U.S. 937 (1958); *see* Henderson v. Bluemink, 511 F.2d 399 (D.C. Cir. 1974); Serbus v. Hoffman, 450 F.2d 296 (8th Cir. 1971); Sullivan v. Kelleher, 405 F.2d 486 (1st Cir. 1968); Larsen v. Gibson, 267 F.2d 386 (9th Cir. 1959); Skinner v. Nehrt, 242 F.2d 573 (7th Cir. 1957); *cf.* Lewis v Brautigam, 227 F.2d 124 (5th Cir. 1955).

[24] 386 U.S. 547 (1967).

[25] *Id.* at 554. Mr. Justice Douglas, dissenting, stated that

> [a] judge is liable for injury caused by a ministerial act; to have immunity the judge must be performing a judicial function. . . . The presence of malice and the intention to deprive a person of his civil rights is wholly incompatible with the judicial function. When a judge acts intentionally and knowingly to deprive a person of his constitutional rights he exercises no discretion or individual judgment; he acts no longer as a judge, but as a "minister" of his own prejudices.

Seventh[29] Circuits applied this doctrine to prosecutors, reasoning that the absolute immunity afforded to judges under section 1983 extends to other quasi-judicial officials where the court has general jurisdiction of the subject matter.

While the courts of appeals have consistently held that quasi-judicial officials are immune from section 1983 damages for acts committed within the scope of their duties,[30] many of the circuits are in conflict over the "scope" of a prosecutor's duties—and therefore the type immunity to be afforded.[31] The Third[32] and Ninth[33] Circuits, conforming closely to the approach of the First, Second, Fourth, and Seventh Circuits, have held that prosecutors are absolutely immune from civil liability when acting within the scope of their duties. There seems, however, to be no limit to the scope of a prosecutor's duties since both circuits have held that the knowing use of perjured testimony does not override the immunity.[34] In contrast, the Fifth[35] and Sixth[36] Circuits, although adhering to the "scope of duties" test, have held that the deliberate suppression of exculpatory evidence is beyond the scope of "duties constituting an integral part of the judicial process."[37] Notably, the Eighth Circuit has departed from the tradi-

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Id. at 567 n.6 (Douglas, J., dissenting)(citations omitted).

[28] Sullivan v. Kelleher, 405 F.2d 486 (1st Cir. 1968) (judicial immunity granted to prosecutors).

[27] Blouin v. Dembitz, 489 F.2d 488 (2d Cir. 1973) (common law immunities apply to section 1983).

[28] McCray v. Maryland, 456 F.2d 1 (4th Cir. 1972) (immune because prosecutors possess a discretion similar to judges); *accord*, Weathers v. Ebert, 505 F.2d 514 (4th Cir. 1974), *cert. denied*, 96 S. Ct. 1480 (1976).

[29] Brown v. Dunne, 409 F.2d 341 (7th Cir. 1969) (prosecutor has *judicial* immunity).

[30] *Cf.* Auler, *Actions Against Prosecutors Who Suppress or Falsify Evidence*, 47 TEXAS L. REV. 642, 644 & n.18 (1969).

[31] See notes 32 through 38 and accompanying text *infra*.

[32] United States *ex rel.* Birnbaum v. Dolan, 452 F.2d 1078 (3d Cir. 1971) (immune if not clearly outside jurisdiction); *accord*, United States *ex rel.* Moore v. Koelzer, 457 F.2d 892 (3d Cir. 1972); Bauers v. Heisel, 361 F.2d 581 (3d Cir. 1966).

[33] Sykes v. California, 497 F.2d 197 (9th Cir. 1974)(immune as long as acting within the scope of duties or "authorized by law to do the act complained of"); *accord*, Clark v. Washington, 366 F.2d 678 (9th Cir. 1966); Robichaud v. Ronan, 351 F.2d 533 (9th Cir. 1965).

[34] Imbler v. Pachtman, 506 F.2d 1301 (9th Cir. 1975), *aff'd*, 96 S. Ct. 984 (1976); Kauffman v. Moss, 420 F.2d 1270 (3d Cir.), *cert. denied*, 400 U.S. 846 (1970).

[35] Guerrero v. Barlow, 494 F.2d 1190 (5th Cir. 1974); Norton v. McShane, 332 F.2d 855 (5th Cir. 1964).

[36] Lynch v. Johnson, 420 F.2d 818 (6th Cir. 1970); *cf.* Peek v. Mitchell, 419 F.2d 575 (6th Cir. 1970).

[37] Madison v. Purdy, 410 F.2d 99 (5th Cir. 1969); *accord*, Hilliard v. Williams, 465 F.2d 1212 (6th Cir.), *cert. denied*, 409 U.S. 1029 (1972)(Deliberate suppression of evidence is "outside the officer's quasi-judicial capacity and beyond the scope of [his] duties."). Thus,

> a quasi-judicial officer, such as a prosecuting attorney, who acts outside the scope of his jurisdiction and without authority of law, cannot shelter himself from liability by the plea that he is acting under color of office.

Lewis v. Brautigam, 227 F.2d 124, 129 (5th Cir. 1955).

tional view, granting a good faith, probable cause defense to prosecutors.[38]

In 1974, in an apparent attempt to clarify the confusion among the circuits, the Supreme Court once again addressed the issue of section 1983 immunities.[39] In *Scheuer v. Rhodes*,[40] relatives of students shot at Kent State sought damages from, among others, the Governor of Ohio. The Court stated that damages against public office holders are a permissible remedy in some circumstances. Going further, however, the Court held that officers of the executive branch possess a qualified, good faith immunity, dependent upon the discretion accorded the officials in their respective positions.[41] This good faith standard was emphasized in *Wood v. Strickland*,[42] where the Court held that a school board member is not immune from section 1983 damages if he knew or reasonably should have known that the action he took would violate the constitutional rights of the student affected or if he took the action with a malicious intent to deprive the student of these rights.[43] *O'Connor v. Donaldson*[44] extended the "knew or should have known" test to other 1983 damage actions against public officials,[45] returning the lower courts to turmoil.[46]

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[38] Wilhelm v. Turner, 431 F.2d 177 (8th Cir. 1970), *cert. denied*, 401 U.S. 947 (1971)(dictum).

> This is the same defense commonly granted to police, recognizing that [the police] should not be liable if they acted in good faith and with probable cause in making an arrest . . . . Under the prevailing view in this country a peace officer who arrests someone with probable cause is not liable for a false arrest simply because the innocence of the suspect is later proved.

Pierson v. Ray, 386 U.S. 547, 555 (1967). *See also* Missouri v. Fidelity & Deposit Co., 179 F.2d 327 (8th Cir. 1950).

[39] Scheuer v. Rhodes, 416 U.S. 232 (1974).

[40] 416 U.S. 232 (1974).

[41] *Id.* at 238-48.

> [I]n varying scope, a qualified immunity is available to officers of the executive branch of government, the variation being dependent upon the scope of discretion and responsibility of the office and all the circumstances as they reasonably appeared at the time of the action on which liability is sought to be based. It is the existence of reasonable grounds for the belief formed at the time and in light of all the circumstances, coupled with good faith belief, that affords a basis for qualified immunity of executive officers for acts performed in the course of official conduct.

Id. at 247-48.

[42] 420 U.S. 308 (1975).

[43] *Id.* at 322.

[44] 422 U.S. 563 (1975).

[45] *See id.* at 577. The relevant question for the jury was whether the official

> knew or reasonably should have known that the action he took within his sphere of official responsibility would violate the constitutional rights of [the plaintiff], or if he took the action with the malicious intention to cause a deprivation of constitutional rights or other injury to [the plaintiff].

Id. at 577, *quoting* Wood v. Strickland, 420 U.S. 308, 322 (1975).

[46] *See, e.g.*, Bryan v. Jones, 519 F.2d 44 (5th Cir. 1975), *rev'd en banc*, 530 F.2d 1210 (5th Cir. 1976). *Bryan* was a section 1983 action for false imprisonment against a sheriff and his employees. Judge Clark stated that since section 1983 is to be read against the background of traditional tort liability, "good faith [is] a defense to a suit under section

In the instant case the Court once again attempted to resolve the conflict among the circuits. Speaking through Mr. Justice Powell,[47] the Court reaffirmed the doctrine that section "1983 is to be read in harmony with general principles of tort immunities rather than in derogation of them."[48] Emphasizing that a prosecutor enjoys an immunity based on public policy at common law, Mr. Justice Powell stated that section 1983 has not abrogated that immunity.[49] Since a mere qualified immunity would undermine the performance of a public prosecutor's duties, the Court held that an absolute immunity serves a broader public interest, even though the genuinely wronged defendant will be left without civil redress.[50] Emphasizing that a prosecutor is still subject to ethical and criminal sanctions, the Court concluded that a prosecutor is absolutely immune from civil liability for all acts committed within the scope of his duties.[51]

Mr. Justice White concurred,[52] stating that the common law immunity afforded to prosecutors rested on the necessity of protecting the judicial process. He argued that an absolute immunity should be limited to situations where the prosecutor decides to prosecute without probable cause, even if maliciously, and to suits based solely on claims that the testimony of a witness called by the prosecution was false.[53] Mr. Justice White, however, maintained that where the prosecutor unconstitutionally suppresses exculpatory evidence, he is acting beyond the scope of his duties and should be afforded only a qualified immunity.[54]

By holding that a state prosecutor's deliberate suppression of exculpatory evidence and knowing use of materially false testimony are not actionable, the Court has given a free rein to prosecutors to pursue convictions using virtually any means, without risk. The length to which a prosecutor will go to convict an accused—and consequently deprive him of his constitutional rights—is evidenced in the case of *Hilliard v. Williams*.[55] In that case the defendant was convicted of second-degree murder solely on circumstantial evidence. The most damning evidence against the defendant was a jacket she was wearing at the time of her arrest which appeared to be bloodstained. At trial the prosecutor

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1983 only where it is *also* a defense 'under the prevailing view [of tort law] in this country.'" *Id.* at 45 (emphasis in original). Thus, the court held that discretion is necessary to make good faith a defense, although the Supreme Court did not make this distinction in *O'Connor*.

[47] Joining Mr. Justice Powell in the opinion of the Court were Mr. Chief Justice Burger and Mr. Justices Stewart, Blackmun, and Rehnquist. Mr. Justice Stevens did not participate in the consideration of this case.

[48] Imbler v. Pachtman, 96 S. Ct. 984, 989 (1976).

[49] *Id.* at 992.

[50] *Id.* at 993.

[51] *Id.* at 994. The Court failed to delineate the scope of a prosecutor's duties, though it clearly held that the deliberate suppression of material evidence and the knowing use of perjured testimony were within the scope of these duties. *Id.* at 995.

[52] Joining Mr. Justice White in his separate opinion were Mr. Justices Brennan and Marshall.

[53] 96 S. Ct. 984, 1000 (1976) (White, J., concurring).

[54] *Id.* at 1001.

[55] 465 F.2d 1212 (6th Cir. 1972), *aff'd after remand*, 516 F.2d 1344 (1975), *vacated and remanded in light of* Imbler, 96 S. Ct. 1453 (1976).

argued that these stains were of human blood and, as a result, the defendant was convicted. While in jail, Mrs. Hilliard learned that the prosecutor had deliberately suppressed an FBI report which established that the stains were not of blood. On the basis of this new evidence, the defendant was granted a new trial and subsequently acquitted. Defendant then brought a section 1983 action for damages which the Sixth Circuit held stated a cause of action.[56] The present decision, however, rejects such a result; the genuinely wronged, innocent defendant is now without a remedy.[57] Although the prosecutor is subject to ethical and criminal sanctions,[58] the only remedy available to the convicted defendant is possible reversal on appeal—if an appeal is undertaken[59]—or release through habeas proceedings. The defendant will remain uncompensated for the expense and humiliation of undergoing a, perhaps, unnecessary trial and will not be recompensed for the time spent in jail—time which can never be recovered.

Although it is necessary to protect the honest, conscientious prosecutor from vexatious lawsuits, it is imperative that the dishonest prosecutor be discouraged from securing convictions at the expense of the constitutional rights of his victims. Accordingly, any available deterrent should be used to accomplish the goal of the criminal justice system—the triumph of justice, rather than the conviction of defendants. Since a qualified immunity would not only protect the innocent prosecutor, but also compensate those defendants wronged by the malicious or corrupt prosecutor, it is submitted that an immunity based on an actual malice standard would better serve the public interest.[60] Nonetheless, the law is clear that the persecuted defendant will now remain without civil redress no matter how malicious or corrupt the motives of the state "persecutor" may be.[61] The state courts are now forced into the position of primary guardians of

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[56] *Id.*

[57] See notes 50 & 51 and accompanying text *supra*.

[58] See note 51 and accompanying text *supra*.

[59] In some jurisdictions less than 30 percent of all convicted felons appeal. Of these, only 10 to 20 percent are reversed. Y. KAMISAR, W. LEFAVE & J. ISRAEL, BASIC CRIMINAL PROCEDURE 14-15 (4th ed. 1974).

[60] *See* Comment, *supra* note 7.

[61] See note 51 and accompanying text *supra*.

[62] *Cf.* Hicks v. Miranda, 422 U.S. 332 (1975) (Stewart, J., dissenting).

This case can be viewed as simply another facet of the Burger Court's current trend to cut back or altogether abolish section 1983 litigation. *See, e.g.*, Washington v. Davis, 96 S. Ct. 2040 (1976) (discriminatory purpose necessary for equal protection violation); Paul v. Davis, 96 S. Ct. 1155 (1976) (reputation not protected by due process clause); Rizzo v. Goode, 96 S. Ct. 598 (1976)(police force—failure to establish that any of the named defendants had, by their own actions, engaged in the deprivation of constitutional rights precluded equitable relief); Doran v. Salem Inn Inc., 422 U.S. 922 (1975) (bad faith harassment necessary to enjoin state criminal proceeding instituted before proceedings of substance on the merits in federal court); Hicks v. Miranda, 422 U.S. 332 (1975) (same), *noted in* 47 MISS. L.J. 143 (1976); Huffman v. Pursue, Ltd., 420 U.S. 592 (1975) (federal court cannot enjoin state quasi-criminal proceedings absent bad faith harassment); O'Connor v. Donaldson, 420 U.S. 308 (1975)(bad faith necessary for section 1983 damages); Jackson v. Metropolitan Edison Co., 419 U.S. 345 (1974) (termination of utility service to household is not state action); Allee v. Medrano, 416 U.S. 802 (1974)(pattern

constitutional rights, a role traditionally reserved to the federal courts.[62]

Frank J. Hammond III

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of harassment necessary to enjoin unconstitutional police conduct); Scheuer v. Rhodes, 416 U.S. 232 (1974)(executive immunity under section 1983); Edelman v. Jordan, 415 U.S. 651 (1974)(no section 1983 damages can be collected from individual defendants if they would come from the state treasury); City of Kenosha v. Bruno, 412 U.S. 507 (1973)(governmental subdivision is not a person under section 1983); Younger v. Harris, 401 U.S. 37 (1971)(bad faith harassment necessary to enjoin state criminal proceeding).

BOOK REVIEWS

1975 GUIDEBOOK TO LABOR RELATIONS (15th Ed.)

Chicago: Commerce Clearing House, Inc. 1975.
Pp. 392, $8.50.

*Armin J. Moeller, Jr.**

The *1975 Guidebook to Labor Relations* attempts, in the words of its publisher, "to put today's labor relations rules in sharp focus." The subject matter is defined "as covering collective concerted action by employees and the relationships between Unions, on the one hand, and employers or employees, on the other." The major federal enactments, Railway Labor Act, Norris-LaGuardia Act, National Labor Relations Act, Taft-Hartley Act, and the Labor-Management Reporting and Disclosure Act of 1959, which form the bedrock of labor relations law and practice are succinctly explained. Special emphasis is devoted to the National Labor Relations Act (NLRA) because of its broad impact and interrelations with other labor laws. The book traces the NLRA's development explaining the interpretations attributed to it by the National Labor Relations Board (NLRB) and the courts. Chapter 3 thoughtfully departs from the book's legal format to discuss labor's basic objectives, often overlooked in an attorney's analysis of a labor problem.

Chapters 4 through 16 seek to deliver on the publisher's initial claim by focusing on the rights and obligations imposed upon parties under federal labor statutes and the means of enforcing them. The book effectively condenses the NLRB's employee representation process, from the initial filing of a union's petition through the election and objections determining the outcome, into one comprehensible chapter. Chapter 5 offers a summary of unfair labor practices, thus affording the reader an opportunity to focus on his area of interest before plunging into the detailed unfair labor practice thicket found in chapters 6 through 11. The three chapters which follow explain the highlights of collective bargaining, the duties imposed upon parties which have a bargaining obligation, and the third party assistance available to them both by law and contract for the mediation and conciliation of labor disputes and contract administration. The last two chapters inform the reader of the reports required of, and the controls imposed upon, labor organizations by federal law to discourage criminal activities and the special rules applicable to the union activities of government employees.

The *1975 Guidebook* is not without its technical shortcomings. Thus, it reprints the NLRA's definition of the term "employer" as it appeared before the 1974 health care amendments, but accurately reflects these 1974 changes in other sections; and the book refers to Section 8(e) of the NLRA in two instances where Section 8(c) is intended. Its most apparent deficiency is the editors'

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attempt to simply insert paragraphs or sentences to explain the 1974 health care amendments in many areas where a general reworking of the text was warranted.

The *1975 Guidebook's* most serious defect is its failure to mention the 1975 amendments to the Freedom of Information Act and their possible impact on discovery in NLRB proceedings. By the date of publication the United States Supreme Court had discussed these amendments in *NLRB v. Sears, Roebuck* & Co.,[1] and one United States district court had ordered disclosure of previously sacrosanct NLRB investigatory files.[2] A primary motive for purchasing a new edition of an annual labor relations reference work is to stay abreast of new developments; this year, the *1975 Guidebook* does not accomplish that purpose.

This discussion of the work's shortcomings, however, is not intended to subvert its solid achievements. As a general reference work in the labor relations field, the *1975 Guidebook* still ranks among the best. It does bring today's labor relations rules into focus. It cannot, nor can any other general reference work, supply answers to today's complex and multifaceted labor relations problems. Within its obvious limitations, the *1975 Guidebook* can assist the nonlabor attorney in identifying the problem sufficiently to research it or seek the assistance of those with expertise in the field.

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[1] 421 U.S. 132 (1975).

[2] Kaminer v. NLRB, 90 LRRM 2270 (S.D. Miss., Aug. 14, 1975); *See also* Cessna Aircraft Co. v. NLRB, 405 F. Supp. 1042, 90 LRRM 2376 (D. Kan., Aug. 21, 1975).

Appellate Judicial Opinions

By Robert A. Leflar
St. Paul: West Publishing Company. 1974. Pp. 343.

*Harry G. Walker**

This book was inspired by a realization of the diverse viewpoints of the many judges who, since 1956, have attended the Appellate Judges Seminars sponsored by the Institute of Judicial Administration of the New York University School of Law. According to Chief Justice Warren E. Burger:

> The viewpoints of seminar participants reflected a variety of views among judges in general and led us to realize the need for a 'handbook' that would assemble, synthesize and order the most pertinent materials on the role of appellate courts and the function of appellate opinions.

The book delves into the knotty problems of judicial opinion writing; encompassing technique, form, and function of the appellate opinion. It is, in the main, a compilation of the wisdom of great law judges and jurists who have spoken on the opinion-writing and opinion-function problems that typically trouble appellate judges, especially newly named judges. The excerpts from these writings are complete enough to convey their own message, but they also fulfill a second purpose by creating an appetite for further reading on the subject.

The subject matter of *Appellate Judicial Opinions* is broken down into 14 categories: The Appellate Judicial Function, Stare Decisis-Precedent, Courts and Statutes, The Function of Opinions, Decisional Techniques, The Overruling Process, The Writing of Opinions, Dissenting and Concurring Opinions, Judicial Philosophies (Judge-Made Law), The Judge and His Court, Law Clerks and Legal Assistants, Judicial Conduct and Misconduct, Publication of Opinions, and Judicial Education.

The author's statement in the second paragraph that "[e]very item in this . . . [book] calls for thought, not for uncritical acceptance . . ." lays the groundwork for the multi faceted, diverse, and sometimes contradictory philosophies covered by the excerpts which follow. For example, in the chapter on stare decisis, the author has, among others, the following quotations[1] characteristic of the treatment of other subjects throughout the book:

> I accede to the authority of the case, though I think it a very strong decision. It does not convince me; it overcomes me.[2]
>
> It is revolting to have no better reason for a rule of law than that

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* Associate Justice, Supreme Court of Mississippi; LL.B. 1952, University of Mississippi.

[1] These excerpts were selected because of their brevity—others cover many pages and deal at length with the subject matter being emphasized.

[2] Mearing v. Hellings, 153 Eng. Rep. 661, 662 (1845) (Alderson, B.).

> so it was laid down in the time of Henry IV. It is still more revolting if the grounds upon which it was laid down have vanished long since, and the rule simply persists from blind imitation of the past.[3]
>
> [W]hile unconstitutional exercise of power by the executive and legislative branches of government is subject to judicial restraint, the only check upon our own exercise of power is our own sense of self-restraint.[4]

Chapter 7 gives the reader an insight into the effort expended and agony experienced by the appellate judge in his search for, and pronouncement of, the law in a given case. It also deals in depth with the practical and tedious aspects of the opinion writing process, such as form, grammar, punctuation, and sentence structure. Chapter 7 also includes helpful suggestions on opinion writing and a wealth of references for further study and reading on the subject. A quote from Justice Louis Brandeis found in this chapter is worthy of note: "There is no such thing as good writing. There is only good rewriting." As to the length of opinions, the author notes that the general consensus among lawyers is that appellate opinions are too long; however, where the lawyer's own case is involved, the winner is rarely critical of the length while the loser often feels that his points were not adequately discussed.

Chapter 11 provides some tips and techniques especially helpful to prospective supreme court research assistants.

Appellate Judicial Opinions is ably presented in logical sequence, and although of particular interest to appellate judges involved in the opinion writing process, it should be of interest to legal scholars and professors of law.

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[3] Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

[4] United States v. Butler, 297 U.S. 1, 78-79 (1936) (Stone, J., dissenting).

A Theory of Justice

By John Rawls
Cambridge, Mass.: Harvard University Press. 1971.
Pp. 607. $15.00.

*Erwin Neumaier**

A Theory of Justice is a long and ambitious work. In roughly 600 pages of longwinding arguments, spliced with referrals backward and forward, Professor Rawls tries to formulate a full and systematic alternative to the various forms of utilitarianism dominating our moral thinking and actions. Utilitarianism, according to the author, has been "espoused by a long line of brilliant writers" who gave the doctrine the classic and systematic form which accounts for its prevalence. The opponents of utilitarianism, by contrast, were selective, unsystematic, and relied mainly on intuitionism. Rawls, who intuitively rejects utilitarianism, tries to remedy this situation by attempting to "generalize and carry to a higher order of abstraction the traditional theory of the social contract as represented by Locke, Rousseau, and Kant." Although he disclaims any originality for his views, he maintains that his theory is "superior" to any other.

In substance this opus magnus is the summation and refinement of more than a decade of reflection previously expressed in various articles. It is divided into three parts, simply entitled "Theory," "Institutions," and "Ends."

The core components of the theory of justice proper are the "two principles of justice" and their derivation from the "original position." The two principles pronounce that (1) "each person is to have an equal right to the most extensive total system of equal basic liberties compatible with a similar system of liberty for all," and (2) "social and economic inequalities are to be arranged . . . to the greatest benefit of the least advantaged" and "attached to offices and positions open to all under conditions of fair equality of opportunity." They are in "lexical" order; therefore, the first principle always has priority over the second and can be restricted "only for the sake of liberty" itself.

Rawls arrives at these principles by taking recourse to a hypothetical "original position," something like the traditional "state of nature." We are to imagine a group of rational, self-interested persons in a hypothetical choice situation where they decide on the principles that shall govern their future conduct. In order to free the representatives from their prejudices and to insure impartiality, they are shrouded in a "veil of ignorance" which conceals all concrete knowledge concerning their beliefs, their conception of the good, and their actual position and fortune in society. They are, however, quite familiar with general scientific principles. The choice behind the "veil of ignorance" is a dramatic way of restricting human selfishness and introducing some common good where there is neither a God-given order nor altruism. Only enlightened self-interest exists.

Having established the abstract principles of justice in this fancy way, Rawls attempts to illustrate how they might be applied to social institutions and

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what duties and obligations arise from them for the individual. He uses the institutions of democracy for demonstration because they are most in harmony with his principles. While Rawls denies that the principles are restricted to constitutional democracy, he argues that "a state of near justice requires a democratic regime."

The application of the principles is explained in a "four stage sequence." This is an extension of the contract model of the "original position" (stage 1) to the constitution framing process (stage 2), the law making process (stage 3), and the rule application by both judicial and administrative officers (stage 4). At each successive step the previously established rules are binding and the veil of ignorance is progressively lifted. In this way the principles of justice become operative in ever greater detail and concreteness. People with a sense of justice will increasingly feel a heavy obligation to obedience which in turn produces stability. The right to civil disobedience under specified conditions, however, is recognized. The whole discussion is dominated by the American experience and, therefore, will probably stike a cord of agreement with the "considered" (socialized) judgments of many liberal Americans in the Lockean tradition.

Finally, Rawls tries to support the principles of justice in human nature. The original position is not a historical or political reality but is merely a contrivance for the articulation of the principles of justice. Do the principles find support in human reality? Rawls argues that man has an innate "sense of justice," that "humankind has a moral nature." This sense of justice, however, is initially only a "capacity . . . possessed by the overwhelming majority of mankind" in various degrees. In order to realize this capacity man has to go through a learning process which at the same time presupposes the conception of justice as guidance and also leads to that conception as an end. Rawls divides the process of acquiring "an understanding of an attachment to the principles of justice" into "moralities of authority, of association, and of principle." The three modalities which mutually suppose and support each other are based on the so-called three psychological laws of (1) love among parents and children, (2) mutual friendship and trust among equals, and (3) the recognition of just and enduring institutions as beneficial to all. With this circular argument Rawls finds the principles announced at the beginning confirmed.

Where did the 600 pages of highly abstract reasoning in a heavy prose lead us? Inescapably, the paramount conclusion is that justice, in the final analysis, depends on our feelings and inclinations. Rawls thinks that his theory is to be preferred to others, especially utilitarianism, because it would be psychologically more acceptable. He admits that he has not proven anything and that his theory is not wholly satisfactory, but he hopes to have given us a theory that makes it possible to articulate and support our sense of justice, i.e., feelings. In this respect *A Theory of Justice* is certainly full of arguments, but it lacks substantive reason. It confirms and reinforces the beliefs and arguments of those who already believe in, or are inclined toward, the contract theory. *A Theory of Justice* is not a substantive philosophical treatise on the nature and essence of justice, but is rather an ideological or rhetorical tract in defense of liberalism and constitutional democracy. Rawls wanted to give us some objective standards of justice derived from man as a rational, self-interested, autonomous individual. Like his predecessors he failed because if there is nothing but feel-

ings and wants at the beginning, one will not get anything else at the end. For the theory to work, to borrow a phrase from Rousseau, "effect would need to be capable of becoming cause . . . men would need to be prior to the laws, what they are to become through them."[1]

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[1] J. ROUSSEAU, THE SOCIAL CONTRACT book II, ch. 7 (1762).

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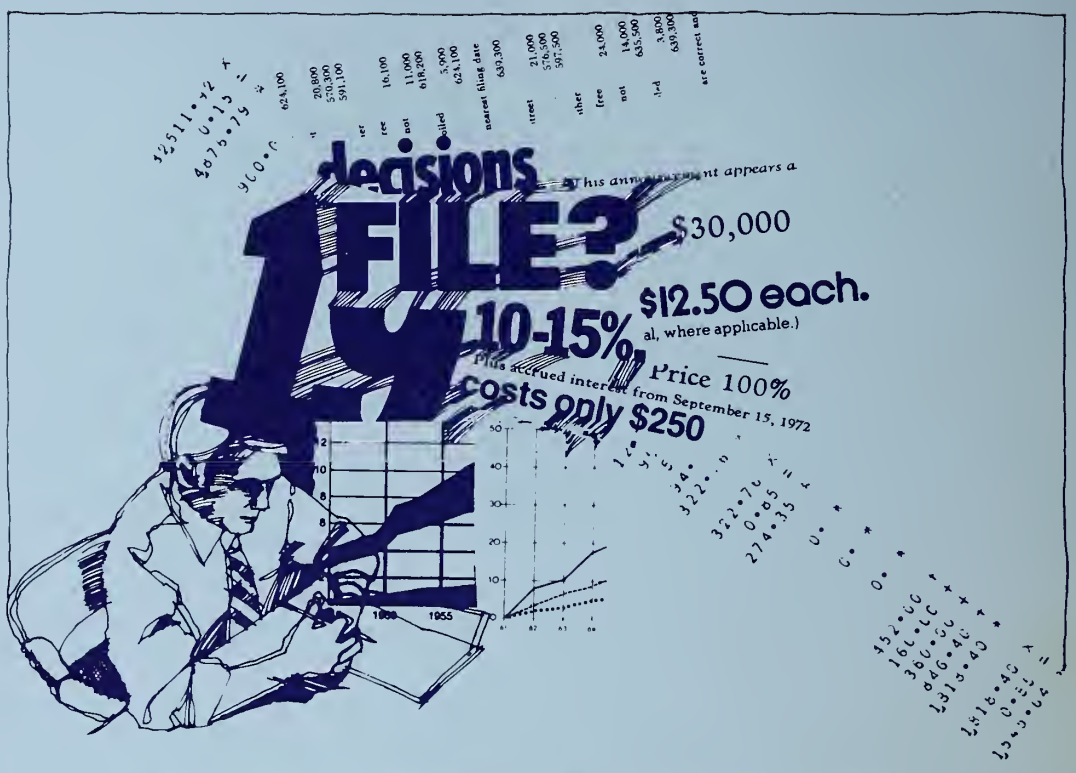

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